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**HOW TO MAXIMIZE YOUR RECOVERY
AFTER THE FIDELITY CLAIM HAS BEEN SETTLED**

> PRACTICAL CONSIDERATIONS <

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A fidelity claim involves a tremendous amount of investigation, analysis of records and testimony, possibly prolonged litigation and negotiation. Often, the surety reaches a point of settlement of the claim. When the posturing during litigation ceases, the insured and the surety reached an acceptable settlement. While the parties may have agreed to the numbers, there still remains a substantial amount of work to be done.¹ The surety must make decisions concerning subrogation and the terms of the settlement agreement. Often, the settlement agreement will serve as an excellent vehicle for adding additional terms or agreements which may be missing from the policy itself. This paper will summarize the concluding steps the surety should consider when it settles the insured's claim in order to maximize the recovery.

A. Bond and Policy Provisions

Various policy forms exist regarding subrogation duties of the principal and the insured. An example of two such forms are listed below.

The Financial Institution Bond, Standard Form No. 24 (rev. 1986) provides:²

Section 7:

- (a) In the event of payment under this bond, the Insured shall deliver, if so requested by the Underwriter, an assignment of such of the Insured's rights, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.
- (b) In the event of payment under this bond, the Underwriter shall be subrogated to all of the Insured's rights of recovery therefor against any person or entity to the extent of such payment.
- (c) Recoveries, whether effected by the Underwriter or by the Insured, shall be applied net of the expense of such recovery first to the satisfaction of the Insured's loss which would otherwise have been

¹ An excellent resource regarding fidelity claims is Handling Fidelity Bond Claims, Michael Keeley, Timothy M. Sukul, Eds., TIPS, ABA (1999). These are chapters analyzing in great detail the various issues in the fidelity claims.

² Financial Institution Bond, Standard Form No. 24.

paid but for the fact that it is in excess of either the Single or Aggregate Limit of Liability, secondly, to the Underwriter as reimbursement of amounts paid in settlement of the Insured's claim, and thirdly, to the Insured in satisfaction of any Deductible Amount. Recovery on account of loss of securities as set forth in the second paragraph of Section 6 or recovery from reinsurance and/or indemnity of the Underwriter shall not be deemed a recovery as used herein.

- (d) Upon the Underwriter's request and at reasonable times and places designated by the Underwriter the Insured shall
 - (1) submit to examination by the Underwriter and subscribe to the same under oath; and
 - (2) produce for the Underwriter's examination all pertinent records; and
 - (3) cooperate with the Underwriter in all matters pertaining to the loss.
- (e) The insured shall execute all papers and render assistance to secure the Underwriter the rights and causes of action provided for herein. The Insured shall do nothing after discovery of loss to prejudice such rights or causes of action.

The Crime Policy/Declarations Form A provides:³

- (a) Any recoveries, less the cost of obtaining them, made after settlement of loss covered by this insurance will be distributed as follows:
 - (1) To you, until you are reimbursed for any loss that you sustained that exceeds the Limit of Insurance and the Deductible Amount, if any;
 - (2) Then to us, until we are reimbursed for the settlement made;
 - (3) Then to you, until you are reimbursed for that part of the loss equal to the Deductible Amount, if any.
- (b) Recoveries do not include any recovery:
 - (1) From insurance, suretyship, reinsurance, security or indemnity taken for our benefit; or
 - (2) Of original "securities" after duplicates of them have been issued.

³ Crime General Provisions. CR 10 00 0695.

B. The Principal

During the claim investigation and negotiations, the surety will have obtained substantial information concerning the principal. Regarding subrogation, the questions include who he is and whether any subrogation efforts will bear fruit. It is important that the surety make an independent evaluation of Principal's ability to repay the loss and how they spent the money. This is true because, in many cases today, employees will steal funds to finance their drug habits. As a result, the Surety's ability to recover is often remote. On the other hand, there still exist those thieves who steal to better themselves and their families. Vacation homes and other tangible assets may be the benefits of their theft. Such assets may be reached by a successful subrogation action.

At the time of settlement, the surety should have examined in detail the insured's employee files for an understanding of who the principal is and what he has. In addition, there are a number of sources of additional information the surety can use.

1. Asset trace firms will provide a summary of assets, bank accounts and other information of our named insured. These services are done on a fee basis.
2. A number of states have placed on the Internet on-line land records for free legal searches. Therefore, you can search at no cost, at your desk, the property addresses and other information concerning your principal.
3. The search of local court records often yields substantial information such as (1) domestic relations cases will provide a snapshot in detail of the principal's assets at the time of the separation or divorce; (2) lawsuits by creditors can highlight the individual's impaired financial state; (3) other lawsuits with business partners, etc. can disclose other activities that the individual may have been involved.
4. By use of the Internet, a number of sources that were traditionally difficult and time-consuming to use, such as court dockets, land and assessment records are readily available. Court dockets will always be a valuable resource, but were difficult to use. With on-line searching, you can recover the information quickly and cheaply.
5. One telling factor that one must consider is that the principal is probably a first-time offender. In its 2002 report on Occupational Fraud & Abuse, issued by Association of Certified Fraud Examiners, several important characteristics of employee theft are noted.⁴ While the majority of the frauds (64%) are committed by employees, the fraud committed by officers and managers are significantly more costly. Only 7% of fraud

⁴ Journal of Accounting, March 2002, pages 68-72.

perpetrators have been convicted of a previous crime. This survey is consistent with other sides that concluded that most employees who commit frauds are first-time offenders

The result of this survey information is that the wrongdoer will probably not be a hardened criminal. Invariably, the scheme was concocted to avoid internal controls and the loss grew over time. Fearing both the threat of criminal penalties, loss of job and financial assets, some principals want to resolve and settle their claims as soon as possible. In these cases, the settlement would often involve the transfer of assets and the entry of confessed judgment to secure repayment of the debt.

C. Read the Bond or Policy Again!

When you are preparing to settle the claim, it is time to read the bond again. Reading the bond is essential to understand what the surety's rights of subrogation are. Often, the provisions can change from company to company. It is important to read those items because it assists in the overall evaluation and settlement of the claim.

One of the greatest sources of confusion between insureds and their surety is the question of recoupment of expenses of salvage. Most policies provide that the settlement expenses can be offset against the recoveries. While simply phrased, these words can become confusing. Are the expenses of the claim investigation related to the recovery? Since many policies are silent on the definition of those terms and the various interpretations can interact with other exclusions in the policy such as claim expenses, it is important that the settlement agreement address that issue. When settling the claim, the surety should consider including how recovery and subrogation expenses will be allocated.

D. Surety vs. Insured Financial Considerations

When drafting settlement agreements regarding subrogation, it is important for the surety to make the determination on whether they want to pursue subrogation on their own, or whether they want to assign it to the insured. A major factor in this will be the determination of who has the most to win or lose in the recovery. This is the function of the deductible, coverage and the amount of the loss to be paid by the insurer. If the insured only stands to recover \$5,000.00 additional on a \$200,000.00 claim, they will have no interest pursuing subrogation efforts. If they stand to recover \$200,000.00, their interest dramatically changes. As a result, the surety needs to do an evaluation of what is in the best interest of the surety to maximize recovery of any funds.

E. The Insured's "Search for Justice"

The insured often claims the desire to pursue the wrongdoer to the ends of the earth in order to recover money and pursue the dishonest employee. Unfortunately, such noble statements often evaporate when the first bills for the subrogation efforts arrive. Therefore, in any subrogation matter, the surety must consider its business judgment in pursuing the subrogation effort. The key issue is whether the insured will pursue the recovery.

There are various options the surety has: (1) follow the language of the bond; (2) enter into some type of contingency agreement if the principal pursues subrogation efforts; (3) jointly agree on a single counsel to represent collection efforts; or (4) agree on percentage based recovery. All these methods will permit the surety to proceed and evaluate the principal's performance in collecting the debt.

F. Third-Party Claims

Before investigating the claim, the surety needs to determine whether there were any third-parties who were legally liable for the losses.⁵ Third-Parties to consider include the insured's board of directors, accountants and banks. Depending on the scheme, it is possible that other professionals such as lawyers, appraisers, stockbrokers may have acted either negligently or in collusion with the principal. It is important to note that an action against the insured's board of directors are often very difficult to do because of judicially created protections in various states and business considerations. Nevertheless, it is something that should be considered on any checklist of potential parties.⁶

With respect to the professionals and the banks, the surety needs to investigate the claim and determine the likelihood of the theft. Claims against professionals are often expensive to pursue since the third-party normally has available its professional liability insurance and its reputation at risk. Claims against banks involve their failure to properly handle the insured's bank transactions.

With respect to accountants, issues often arise over the deficiency of their audits and whether they should have caught the fraud at an earlier date.⁷ Sureties and the counsel will often employ an accountant consultant to review the work of the accountant in order to provide a basis for determination for litigation. Similar review of the work of the other professionals that may have been used by the insured should be considered. In many cases, professionals will not be implicated or cost of pursuing them will be prohibited in ratio to the loss sustained. Nevertheless, in larger claims, it is very important to consider the role of the third-party to determine whether there are opportunities to pursue negligent actions against third parties who often have the benefit of substantial insurance coverage.

⁵ The insured cannot usually impair the rights of the surety in subrogation actions. An excellent article on this issue is Impairment of Subrogation Rights: What are the Insured's Duties and Obligations to the fidelity Carrier?, Robert J. Donovan and Sam H. Poteet, ABA Mid-Winter Meeting Paper, January 22, 1999.

⁶ Compare differing state law regarding suits against negligent directors by insurers, e.g., Employers Ins. v. Doonan, 712 F. Supp. 1368, 1369 (C.D.Ill. 1989) (Illinois law); and Federal Deposit Ins. Corp. v. National Sur. Co., 434 F. Supp. 61, 63 (E.D.N.Y. 1977)..

⁷ Accounting firms often raise a privity of contract defense which many states recognize. See Ultramares Corp. v. Touche, Niven & Co., 174 N.E. 441, (N.Y. 1931) (to minimize the impact, the surety should obtain an assignment from the principal).

Another category of third-party is the co-conspirator. The principal may have conspired with another business entity or individual in order to implement the theft. It is possible that that third-party may have substantial assets available to satisfy the loss. The surety would file action against the co-conspirator and the principal. While the conspiracy of third-parties is not the norm, it is most likely present in larger fidelity losses when the wrongdoer engages in a larger fraud.

G. Restitution and the Prosecutor

Both the federal government and the various states have statutes which can provide a mechanism of obtaining court-ordered restitution.⁸ The federal system has strict sentencing guidelines that are applied. Restitution can have an impact on such guidelines, so there is a tremendous incentive for the wrongdoer to turn over assets in order to minimize his sentence. Since the federal system severely limits any type of parole, the wrongdoer usually serves the sentenced term. The states have varied degrees of restitution orders. Some state programs work well; others do not. The function of the state in which the claim is located and each state should be judged accordingly.

In both systems, if the wrongdoer fails to timely make the probation payments, it is important that the government probation officer and prosecutor be immediately notified by the surety. Failure to make such payments can have a negative impact on the prisoner. Without notice, the probation officer often does not know about the violation.

It will be interesting to see in the future the number of fidelity of claims that may involve the involvement of the FBI and the U.S. Attorney's Office.⁹ In light of the September 11th attacks on this country, the FBI has completely redefined its role. Clearly, the FBI's focus on enforcement of certain federal laws will change to meet its new job of preventing terrorism. Furthermore, it is readily apparent that in light of the accounting scandals involving a number formerly billion dollar companies, the FBI has deployed large numbers of its available agents to such investigations, such as Enron, WorldCom, Aldephi, and other companies. It will be interesting to see whether prosecuting smaller fidelity losses will remain as important as it once was to the federal government. It is possible that such investigations will be referred to local prosecutors. It will be important to recognize that there could be a fundamental change involving the FBI in fraud investigations. Therefore, the surety will be dealing with more local prosecutors.

In criminal cases, the surety should identify to the prosecutor their interest in the loss. Such a relationship can assist the surety in obtaining the correct restitution orders and penalties. Furthermore, public documents of the criminal investigation can assist in the claim review process.

⁸ See Victim and Witness Protection Act of 1982, 18 U.S.C. § 3663 (West 1995). A copy of the statute is attached as **Exhibit A**.

⁹ Statement of Director Mueller, June 2002. See **Exhibit B** attached hereto.

H. Subrogation Considerations/Settlement Agreements

In drafting the final settlement agreements to settle claims, there are certain specific paragraphs that should be considered and included regarding subrogation. First, the surety, pursuant to the terms of the policy or bonds, should obtain an assignment of the insured's rights. It is important that assignment be broad enough to cover actions that the surety may want to bring against third-parties. The assignment provisions operate to provide the surety a legal basis to assert such claims. Second, specific agreement by the insured to cooperate in the surety's subrogation efforts. This is of assistance in pursuing the actual subrogation efforts. Unfortunately, insureds often lose interest and their matters after they have received their claim draft. While the bond often contains such obligations, it is important to have the principal numbered in the settlement agreement with responsibilities to the surety. Third, the surety should clarify any issues regarding recoveries that may be present. There is no need for any disputes over how expenses will be applied against recoveries, uninsured losses or reimbursement of deductible. Fourth, the surety should consider whether any portion of the claim should be allocated to certain individuals or categories. This is to be considered when parts of the claims are determined not covered under the bond. Fifth, in those rare cases where the wrongdoer is a party to the overall settlement agreement, it is helpful in future litigation or bankruptcy proceedings for the wrongdoer admit to his wrongful actions. Often, this does not occur because the individual is under potential criminal liability. In cases where the wrongdoer has already been convicted or plead to a crime, he or she may agree to such admissions.

I. Conclusions

Recovery of fidelity losses involves a thorough investigation of the available assets of the party to satisfy the claim of the surety. At the same time, the surety recognizes that such investigation and subrogation actions are expensive. Through a careful analysis and consideration of the subrogation issues throughout the claims process, the surety may be able to maximize its recovery.

The surety has available to it rights to sue the wrongdoer. In addition, the surety can assert potential claims against the third-party defendants who may have contributed by their negligent actions to the loss. Finally, the surety should work with the appropriate law enforcement agencies in order to gain their assistance in pursuing the fidelity loss. Often, the principal will be motivated to reimburse the surety when he faces criminal claims. In light of the changing role of the Federal Bureau of Investigations, it is possible that more fidelity investigations will wind up the responsibility of local prosecutors.