

News flash

‘POSH’ Crime

Almost on a daily basis the press reports yet another incidence of financial crime, and gross fraud by management and/or trusted employees. Such losses then translate into substantial insurance claims. Misha Nateghi reports on Employee Fidelity and Commercial Crime Policies, and how the UK insurance market is reacting.

Background

What is “posh crime”? Some examples of the spectacular frauds reported upon, and in some cases, turned into films, are set out below:

- In 1995 the derivatives trader Nick Leeson brought down the collapse of Barings Bank by falsifying accounts and making false misrepresentations, which caused the bank to suffer irrecoverable losses;
- In June 2003, a former fund manager at Deutsche Morgan Grenfell responsible for £300m concealed material facts with a view to converting bonds for his own personal benefit;
- In June 2003 Norwich Union uncovered a scam whereby an employee had inflated the value of filed claims, and siphoned off £1.5m for her own personal benefit;
- In March 2004 Jamie Olis, a mid-level executive of Dynegy Inc. was found guilty of disguising a \$300m loan and accounting fraud, and received a 24 year prison sentence;
- In April 2004 Goldman Sachs secretary, Joyti De-Lavrey was convicted of stealing over £4.4m from her employers, by falsifying signatures;
- In June 2004 the former Chairman and Chief Executive of Versailles were found guilty of defrauding private investors and fraudulently inflating the firm’s turnover by more than £700m. They were handed 6 year prison sentences, and disqualified to act as directors.
- Recently, the Chief Executive of Symbol Technologies and 7 former directors have been charged with orchestrating a \$200m fraud, similar to the scheme which brought down WorldCom.

Statistics reveal that last year there were over 100 convictions for fraud, of which 24 were worth over £5m. As these corporate frauds unfold, they frequently expose matters which are really only intrinsic and long-standing problems of the sort that pervade many corporations, institutions and companies, whether subtle or obvious. Surveys suggest that the most significant risk to businesses are in fact their own operational risks.

It is estimated that the annual cost of corporate fraud in the UK is in the region of £14billion, and on a worldwide basis, a third of all insolvencies occur as a result of corporate fraud.

Recent research suggests that the majority of frauds are perpetrated by employees and senior members of a firm in a position of trust, who are familiar with the internal systems and controls.

The impact of fraud on a business cannot be exaggerated. Not only is this a blow to the company, but there is also the disruption to the organisation, investigative costs, business interruption, damaged morale, potential publicity and reputational impact. Meanwhile, even if losses do not result in insolvency, they can have a potentially damaging effect on the company’s balance sheets.

Law Reform

The Home Office issued a consultation paper in May 2004 to reform the law of fraud. The current law fails to define what “fraud” actually means. Proposals for reform would create a



▶ general offence of fraud which can be committed in 3 different ways: (i) false representation; (ii) wrongfully failing to disclose information; (iii) abuse of office. In each case the behaviour must be dishonest, and must aim to secure a gain for the defendant, or cause loss to another.

The Commercial Crime Policy

There is a product in the insurance market which has been created to provide insurance against losses resulting from certain types of fraud and dishonesty. The Commercial Crime Policy is typically intended to provide cover for any employee for "losses sustained as a direct result of a fraudulent or dishonest act committed with the manifest intent to cause the Insured to sustain such loss".

The key constituents of the policy are:

1. the insured must incur a loss;
2. the loss must have 'resulted directly' from the dishonest or fraudulent acts of an employee;
3. the employee must have committed the act with the 'manifest intent' to cause the insured to suffer the loss sustained; and
4. the employee must have committed the acts with the 'manifest intent' to obtain financial benefit for the employee or a third party, and the financial benefit obtained must not be of a type excluded.

Typically, some of the issues which arise when considering whether a loss is covered, are:

1 Definition of "Employee"

An employee is frequently defined as a natural person, who has entered a contract of service, and must be subject to the Insured employer's direction and control. The definition of an employee does not include a director or partner, except where the director is performing acts, which come within the scope of the usual duties of an employee.

2 "Manifest Intent"

Presently, there are two triggers for the insuring clause to operate; firstly the employee must have intended to cause the Insured the loss; and secondly the employee must have intended to obtain a financial benefit.

Losses caused by carelessness, reckless or deliberate acts not intended to provide any gain, or where an employee has obtained a financial benefit, but has not caused the Insured to suffer a covered loss will not trigger the policy. There must be an act or conscious purpose to cause the Insured to sustain a loss.

This double trigger has recently come under discussion. The Standard Form Number 24 Financial Institution Bond may be revised, to require only a single trigger of active and conscious purpose to cause the Insured a loss.

3 Discovery

Discovery is a central question, since this determines the applicable period of coverage, the Insured's obligation to provide timely notice, cancels (not suspends or excludes), coverage as to any employee, immediately upon discovery by the Insured of any dishonest act.

The Insured must have sufficient facts to lead a reasonable person to believe that the circumstances of loss fall within the scope of the Policy. The standard to be applied is an objective one (reasonable and prudent person would or should conclude). Mere suspicion of dishonest acts or loss is not enough. Moreover, those facts must be viewed at the time of discovery, and not in the light of knowledge subsequently acquired.

4 Loss

The Policy provides indemnity for actual financial loss. Losses resulting from reckless, or negligent acts, consequential and indirect losses, are subject to specific exclusion. The question is whether the Insured would have sustained the same loss without the allegedly covered event, and if the elements of the claim were a direct cause of the loss.

The Policy does not protect employers for acts committed against third parties by their employees. Consequently, settlements with third parties affected by the employee's acts are not covered. The policy is intended to protect only the Insured.

Conclusion

Whilst all companies, institutions and organisations have internal procedures and guidance for their employees, it would be naive to imagine these can provide total protection against rogue employees. Regular monitoring, detection training and a no tolerance policy are possible options. Recently, companies are beginning to screen prospective employees, particularly for senior positions.

Technological advances also pose new risks for businesses as internet usage increases and outsourcing of IT becomes more common. Many wordings now include insuring agreements for fraudulent electronic transfer instructions and computer fraud. This may extend indemnity to include fraudulent acts committed by the staff of IT organisations to which functions are outsourced, thereby broadening the range of cover available.

In the meantime, forensic accountants and fraud specialists say there has been a marked increase in fraudulent activity. Market abuse, false accounting, improper trading, all include aspects which trigger a D&O, E&O and/or Commercial Crime Policy. In the current climate, therefore, would it be altogether surprising to see an upturn in claims activity in this area?

The Financial Institutions Team will be producing a Guide to Commercial Crime Policies, which will include detailed commentary on typical clauses, and policy application.

Should you require any further information regarding issues concerning Financial Institutions and/or Directors and Officers Liabilities, please contact any member of the Financial Institutions Team at Robin Simon LLP.

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