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AN ANALYSIS OF FIDELITY CLAIMS FOR THE MODERN WORLD

November 7–8, 2018
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The Fidelity Recovery Playbook:
Practical Strategies for Maximizing Recovery

By Stefan Dandelles, Matt Kalin, Angela Lee, Jean Liu and Chris McKibbin[1]

"The only sign we have in the locker room is from
The Art of War: 'Every battle is won before it is fought.'"
– Bill Belichick

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1. Introduction

Fidelity insurers are leaving money on the table. The objective of this paper is to ensure that first-party claims handlers and recovery/subrogation personnel are working together strategically to identify potential recovery targets (defaulters, confederates, beneficiaries, auditors and banks), and that they can, where appropriate, deal with first-party and recovery efforts concurrently, so as to maximize recovery. This paper will discuss the use of Mitigation Agreements (also known as Interim Recovery Agreements) to "jump the gun" on recovery efforts prior to the carrier being in a formal subrogated position, and will identify practical litigation strategies and tools that carriers can use to maximize recoveries as against each type of target.

2. The Problem: Fidelity Recovery is not like other Subrogation

Time is the greatest enemy of effective fraud recovery efforts. As time goes by, stolen funds are spent by the defaulter, funds and other assets get conveyed to third parties (innocent or otherwise) or moved out of the jurisdiction, and assets get liquidated to fund the defense of criminal charges. The more time that goes by, the worse position a carrier will be in.

Given this reality, some subrogation professionals still approach fidelity subrogation in a similar manner to other subrogation efforts. Common problems include:

(a) First-party claim professionals not analyzing recovery opportunities and available assets at the outset of the fidelity claim, or not involving subrogation personnel to assist in that analysis while the first-party claim is still fresh.

(b) First-party claim professionals allowing the insured's own counsel to run amok in the recovery effort, notwithstanding that the insured's own counsel might be:

  (i) inexperienced in fraud recovery litigation, and/or

  (ii) substantially more expensive than the carrier's panel counsel, resulting in greatly diminished net recoveries.

(c) Subrogation personnel treating fidelity subrogation like subrogation in third-party liability situations, where the subrogation target is insured and there is a reasonable prospect that the target's carrier will ultimately indemnify its insured in respect of a judgment or settlement of the subrogated claim. This approach can sometimes inculcate a lack of urgency on the part of the subrogation professional.

(d) Waiting for a restitution order to be generated through the criminal process, when:

(i) assets will have already been directly expended on the criminal defense to get to that point; and,

(ii) the delay in getting to that point usually means that remaining exigible assets have either been liquidated or "disappeared".

(e) Waiting for the criminal process to generate a conviction, on the theory that this effectively satisfies the burden of proof in a civil fraud action (it probably does, but what about the delay in getting to that point?)

All of the foregoing are examples of situations where the wrong approach undermined otherwise-viable fidelity recovery efforts.

However, the most common problem — by far — is the carrier taking the view that it has no role to play in recovery efforts until such time as it is formally subrogated by payment of some or all of the first-party claim. This view is understandable, given the general common-law rule in most American and Canadian jurisdictions that a carrier has no subrogation rights until such time as the insured has been indemnified.[2] However, pursuing *subrogation* and pursuing *recovery* are two different things. It is possible to reconcile the urgency necessary for successful fraud recovery with the delay necessitated by first-party claim assessment.

3. The Solutions: Concurrent Handling / Mitigation Agreements

There are two approaches that can help carriers maximize recovery: (i) concurrent handling between the first-party claim professional and the subrogation professional; and, (ii) mitigation agreements between carriers and their insureds.

3A. Concurrent Handling

The first-party claim handler should consider recovery at an early stage of the first-party claim. Where there is a reasonably strong prospect that there will be indemnity under the policy, the claim professional should involve the subrogation professional early on in order to assess recovery potential, through asset investigations and potentially also lining up recovery counsel.

Throughout this process, it is incumbent on the carrier to be open with its insured about their mutual interest in securing available assets. However, where the carrier forms the preliminary view that there are significant coverage concerns, the carrier should communicate this to the insured and also stress that the insured retains the right (and, under some wordings, the obligation) to pursue recovery.

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[2] *E.g.*, *Grant Thornton v. Syracuse Sav. Bank*, 961 F.2d 1042 (2d Cir. 1992); *Somersall v. Friedman*, 2002 SCC 59; *Farrell Estates Ltd. v. Canadian Indemnity Company* (1990), 44 C.C.L.I. 73 (B.C.C.A.).

3B. Mitigation Agreements

As the carrier is not subrogated, the carrier (and recovery counsel acting for the carrier) can only act in the insured's name with the insured's permission, preferably under the terms of a clear written agreement. Several American and Canadian carriers have begun using mitigation agreements to, essentially, "jump the gun" on subrogation, thereby giving them a contractual basis for acting in the insured's name in order to protect recovery potential for both the carrier and the insured.

Mitigation agreements have the following essential elements:

(i) an agreement permitting the carrier to act in the insured's name in taking litigation steps to pursue recovery;

(ii) an agreement permitting the carrier to retain and instruct counsel;

(iii) a provision regarding who pays counsel, including whether fees are to be split, and whether the insured will reimburse the carrier in the event that the claim is not covered;

(iv) a provision regarding allocation of, or priority to, recoveries (net of legal and other expenses), either confirming that the allocation provision in the policy governs or, alternatively, any variation to which the parties agree;

(v) a provision addressing the insured's duty to co-operate in the carrier's recovery efforts, including through provision of records and personnel, together with appropriate provisions regarding privilege; and,

(vi) a clear mutual reservation of rights with respect to the first-party claim.

A sample mitigation agreement[3] is found in the appendix to this article.

Carriers and insureds have significant latitude in the negotiation of mitigation agreements, and can tailor them to the specific exigencies of the loss at issue. For example, where the quantum of the alleged loss significantly exceeds the available limit under the policy, the parties might negotiate a proportionate split of legal and other expenses, and/or a proportionate split of net recoveries which varies from the formula set out in the policy. In such circumstances, the insured can still get the benefit of experienced recovery counsel at reasonable rates, but it is required to contribute directly to maximize the chances of recovering a significant loss that is otherwise uninsured.

[3] The sample mitigation agreement contained in the appendix to this article is for illustrative purposes only and is not intended for use as a binding document.

3C. Parallel Criminal Prosecution

The effect criminal proceedings have on a claim investigation and any potential recovery is a well-canvassed topic.[4] Putting aside the probative nature of a plea or conviction on the determination of coverage for a claim, a criminal prosecution may also affect a carrier's subrogation efforts. For example, an ongoing prosecution could tie up certain necessary documents and/or stifle key witnesses needed on the civil side. On the other hand, a swift criminal prosecution can streamline a recovery effort if it results in a restitution agreement or formal order that appropriately takes into consideration the possibility of an insurance payout to the victim / insured and provides for assignability in some fashion.

3C1. Should the insured contact the police immediately?

A criminal investigation can both aid and impede a claim investigation and later recovery efforts. As with many claim considerations, the starting point is whether the policy requires that the insured report the matter to the police or other law enforcement. Some policies require the insured to advance a parallel criminal complaint, while others do not. Where such a requirement exists, it may be prudent in certain circumstances for the carrier to *not* require strict compliance with it.

There are benefits to involving law enforcement at the outset. Law enforcement and/or the prosecution have broader and swifter access to certain pieces of information. For example, the criminal process may uncover information concerning the alleged perpetrator's assets, or other probative documents like Suspicious Activity Reports. Such information may be obtained later during the subrogation phase, but that is not always a guarantee. The same concept holds true for percipient witnesses. It is more likely that a witness will speak with law enforcement and/prosecutors than a claim or subrogation professional.

However, it may be in both the insured's and the carrier's interest to not contact law enforcement, at least initially. Logistically, an insured may not have the desire or wherewithal to pursue its claim on two fronts. First, if a defaulter is charged criminally, he may (understandably) allocate any available assets to the defense of the criminal charges, rather than making civil recovery. Further, an insured is typically not in the business of internal investigations, and simply cannot devote the resources necessary to chase its loss from multiple angles.

In addition, while law enforcement clearly has greater enforcement power, the claim process often moves at a quicker pace, leading to quicker redress for the loss. Tying the matter up with law enforcement and/or a criminal court may prevent or hinder access to documents and information necessary to prove the claim with the carrier. Finally, the criminal process is a public process. An insured may have an interest in keeping its loss private and out of the public view so as to not deal with the negative public perception.

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[4] Tanya Brown and Adam P. Friedman, *Potential Effect of a Criminal Investigation or Prosecution Upon the Insurer's Investigation of a Fidelity Claim*, 16 Fid. L.J. 133, 145-146 (2010); Cole S. Kain and Cynthia A. Mellon, *Potential Conflicts Between Fidelity Insurers and Insureds: Parallel Proceedings, Interviewing Witnesses, and Actions Against Third Parties,* 5 Fid. L.J. 1, 10-13 (1999).

3C2. Do Criminal Proceedings act as an Automatic Stay of civil proceedings?

Generally speaking, civil and criminal proceedings may proceed concurrently, and a defaulter will typically need to demonstrate exceptional circumstances to secure a stay of civil proceedings pending the resolution of criminal proceedings.[5] One common misconception is that the criminal proceedings must resolve before the commencement of a civil proceeding. As a general rule, this is not true, and the insured and carrier should press on in civil court if that is determined to be the best course of action. If the insured wants or needs to wait out the criminal proceedings for whatever reason, such as confidentiality or lack of access to necessary proof documents, there is always the option for the insured and the carrier to enter into extensions to submit the claim and tolling agreements to preserve all rights.

3C3. Getting evidence / production of documents from criminal proceeding

One of the most important considerations with respect to gaining access to the criminal file is whether the carrier *needs* the materials to process the claim and commence its recovery efforts, or if the materials would simply be "nice to have." While it is often the case that law enforcement has information that would be helpful to a claim investigation (and recovery efforts), carriers usually have to sit idly by and wait for this non-public information. The downside to waiting for the criminal process to complete so as to obtain the necessary proof is significant; generally, the evidence of wrongdoing decreases over time as witnesses' memories fade over time and documents disappear.

While there are certain circumstances where law enforcement will seize the insured's proof documents and restrict the testimony of witnesses, the insured is typically able to satisfy the carrier's document requests and other requests for other information to such an extent that the carrier can make a determination. Absent a seizure of the insured's files, if a carrier has enough material to pay its insured on a claim, it likely has enough information to commence litigation in which it can use the discovery process to refine its case, possibly even on a dispositive motion. In addition, leaving aside questions of strategy, the carrier may not be able to legally wait for the criminal proceedings to produce documents. The carrier has a contractual obligation to pay a covered claim where it has sufficient proof. Waiting around for information other than what the insured is able to provide may not be an option in this regard.

3C4. Plea bargains and Restitution Orders

Where the alleged perpetrator has entered into a plea deal and is ordered to pay made the subject of a restitution, an insured/carrier may use that to its advantage while seeking a civil recovery. The insured/carrier can use the criminal order as leverage against the perpetrator and may even be able to enforce the order through the civil proceedings.[6] However, there are inherent risks in delaying any form of civil action in the hope of obtaining recovery via a

[5] In Ontario, a civil litigant must show that the case is "extraordinary" or "exceptional" in order to procure a stay on the basis of an ongoing criminal proceeding. *Falloncrest Financial Corp. v. Ontario* (1995), 27 O.R. (3d) 1 (C.A.) at paras. 14-16.

[6] *See* section 4A4, *infra*.

restitution order. Once the alleged perpetrator is the subject of any investigation or formal proceedings, assets have a tendency to dry up, disappear or be transferred. The better course of action is to, as early as appropriate, tie up assets via pre-judgment civil orders. In that sense, restitution orders are a solid backup plan — but only a backup plan.

3C5. Ethical Considerations — *Rules of Professional Conduct*

Most states' and provinces' Rules of Professional Conduct restrict an attorney's ability to threaten legal proceedings.[7] That said, there is little to stop the insured from using the pressure of a potential criminal proceeding to drive recovery efforts at the outset of a claim or at the time an insured discovers the loss. While this is a fine line, particularly for insureds using in-house or hired counsel as part of its investigation or separation from the alleged perpetrator, this represents an avenue through which a insured may influence behavior.

In the event that there is a decision to commence civil proceedings, it is usually beneficial for the insured to alert law enforcement or the prosecutor as to the insured's independent pursuit of recovery (while also maintaining any request for a criminal restitution order). This not only maintains an open line of communication and conveys an air of professionalism, but it might also open the door to obtaining information helpful to the advancement of the civil claim.

4. The Targets and the Toolbox

The potential targets in a fidelity recovery scenario typically include the following:

(a) Defaulters;

(b) Co-conspirators;

(c) Beneficiaries of a fraud who are not involved in the defaulter's conduct;

(d) Auditors; and,

(e) Banks.

4A. Defaulters

Where evidence supports an employee dishonesty claim under a fidelity policy, this evidence will typically support a civil claim in fraud, as well as subsidiary causes of action such as conversion and unjust enrichment. In most jurisdictions, this will give rise to a common-law or equitable tracing remedy in favor of the insured. The tracing claim is key, as it lays the evidentiary foundation for attachment and freezing orders over real and personal property.

[7] *See* Illinois Rules of Professional Conduct, rule 1.2(e): A lawyer shall not present, participate in presenting, or threaten to present criminal charges ... to obtain an advantage in a civil matter; Ontario Rules of Professional Conduct, rule 3.2-5(a)(i): A lawyer shall not, in an attempt to gain a benefit for a client, threaten, or advise a client to threaten ... to initiate or proceed with a charge for an offence, including an offence under ... the Criminal Code

Prejudgment attachment and freezing orders are available in most states (and Canadian provinces, where they are referred to as *Mareva* injunctions) where there is reasonable *prima facie* evidence that defalcated funds can be traced into other assets, such as real property, chattels or bank accounts.

In Canadian common-law jurisdictions, the test is as follows:

1. the plaintiff has strong *prima facie* case;

2. there is a real risk that the defendant may dispose of assets prior to trial; and,

3. the balance of convenience favours granting the injunction. [8]

In cases where the plaintiff demonstrates a strong *prima facie* case that defendant defrauded or stole from the plaintiff, the Court is entitled to infer the real risk of disposal of assets, on the theory that if the defendant defrauded the plaintiff, the defendant is also likely to take improper steps to frustrate the court process itself.[9]

In the United States, *Mareva* injunctions are unavailable at common law, but most states provide similar prejudgment remedies in cases of fraud. The U.S. Supreme Court rejected the validity of *Mareva* injunctions in *Grupo Mexicano De Desarrollo v. Alliance Bond Fund*.[10] The Court explained that federal courts' equity jurisdiction is limited to the jurisdiction exercised by the English Court of Chancery at the time the Constitution and Judiciary Act of 1789 were adopted.[11] At that time, a creditor needed to obtain a judgment establishing the debt before a court of equity could interfere with a debtor's use of his property.[12] Because Congress has not subsequently given courts these powers, prejudgment attachment and similar remedies remain unavailable under US federal law.[13]

Most states, however, allow prejudgment attachment when a fraudulent transfer claim is asserted. Some states have codified the procedure for obtaining an attachment order, making the availability and requirements of prejudgment attachment clear, but many states do not have clear-cut guidelines. Although nearly every state has enacted an edition of the Uniform Voidable Transactions Act[14] ("UVTA"), its drafters opted not to address prejudgment attachment, writing "it is frequently unclear whether a state's procedures include a prejudgment remedy against a fraudulent transfer or obligation. Section 7 accommodates prejudgment remedies if available

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[8] *Aetna Financial Services Ltd. v. Feigelman*, [1985] 1 S.C.R. 2.
[9] *Id*. at paras. 18-20.
[10] 527 U.S. 308, 328-329 (1999).
[11] *Id*. at 318-319.
[12] *Id.* at 318-321. The English Court of Chancery also followed this rule until 1975, the year that it decided *Mareva Compania Naviera S. A. v. International Bulkcarriers S. A.*, 2 Lloyd's Rep. 509.
[13] *Grupo*, 527 U.S. at 309.
[14] (Unif. Law Comm'n 2014); Uniform Fraudulent Conveyance Act (Unif. Law Comm'n 1918); Uniform Fraudulent Transfers Act (Unif. Law Comm'n 1984).

under applicable law."[15] Despite the UVTA's deference, some courts have interpreted it in conjunction with other state laws as allowing prejudgment attachment.[16]

Since federal law does not provide for prejudgment attachment orders and uniform acts have not directly confronted the issue, the conditions that must be met to obtain a prejudgment attachment order vary by state. The following examples illustrate some different approaches.

Ohio exemplifies states with a codified procedure. The statute provides that a plaintiff may request attachment at any time after the commencement of an action if it sets forth:

> (a) The nature and amount of the plaintiff's claim, and if the claim is based upon a written instrument, a copy of that instrument;
>
> (b) The facts that support at least one of the grounds for an attachment contained in section 2715.01 of the Revised Code [that defendant has fraudulently or criminally contracted the debt];
>
> (c) A description of the property sought and its approximate value, if known;
>
> (d) To the best of plaintiff's knowledge, the location of the property;
>
> (e) To the best of the plaintiff's knowledge, after reasonable investigation, the use to which the defendant has put the property and that the property is not exempt from attachment or execution[;]
>
> (f) If the property sought is in the possession of a third person, the name of the person possessing the property.[17]

If the plaintiff sets forth these elements and shows it will suffer irreparable injury if the order is delayed until a hearing, the court may issue an order of attachment without notice to the defendant.[18]

Many states, including Ohio, additionally require the plaintiff to post a bond to cover the defendant's costs if the attachment is ultimately found improper. For example, in Florida, the person applying for attachment must make a bond with surety to cover at least double the debt demanded.[19] If the attachment is later found improper, the plaintiff has to pay defendant's costs caused by the improper attachment.[20]

Other states, like New York, maintain the distinction between monetary and equitable remedies. When a plaintiff in New York seeks purely monetary damages, he may not obtain

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[15] Uniform Voidable Transactions Act Prefatory Note.
[16] *Wimbeldon Fund, SPC (Class TT) v. Graybox, LLC*, 2015 U.S. Dist. 134966, at 15 (C.D. Cal) (citing *In re Focus Media, Inc.*, 387 F.3d 1077, 1085 (9th Cir. 2004).
[17] Ohio Rev. Code Ann. § 2715.03 (LexisNexis 2018)
[18] *Cedar Creek Mall Props., L.L.C. v. Krone*, 2017-Ohio-7884, ¶ 42 (Ct. App.) (quoting R.C. 2715.045(A)).
[19] Fla. Stat. § 76.12 (2018).
[20] *Id.*

prejudgment attachment — even in cases of fraud. In a recent case, the plaintiff alleged defendants violated New York's Fraudulent Conveyance Act and that they owed him money damages and a 10 per cent ownership interest in an LLC.[21] The court denied his request for a preliminary injunction to freeze defendants' assets (citing *Grupo*), but found that the plaintiff was entitled to a preliminary injunction freezing the 10 per cent ownership interest defendants held in the LLC.[22]

4A1. Constructive Trusts

If the fraudster disposes of the stolen money before the victim is able to freeze the fraudster's assets, the victim can attempt to impose a constructive trust. A constructive trust essentially allows the owner of stolen property to recover any proceeds, profit, or other property that has been acquired in exchange for the stolen property. Some states, like California, have codified constructive trusts.[23] Others, like Delaware, recognize constructive trusts as one of a court's equitable powers permitted by the UFTA.[24] Canadian common-law jurisdictions utilize the constructive trust as an equitable remedy.[25] To impose a constructive trust, the victim (or in some cases, the carrier), after filing suit, must trace the property in question to the stolen funds and show that the third party's retention of the property would be unjust enrichment.

4A2. Locating Assets — Asset Investigations and Norwich Orders

Many qualified investigative firms offer asset investigations. The employee personnel file is often a useful starting point for an asset investigation, in that it provides personal details, bank account information and a residential address, all of which can be used to develop an asset profile.

However, there are also litigation-specific steps that can assist in developing the asset profile. In many states, it is possible to obtain a defaulter's bank records. For example, Texas requires financial institutions to produce records if the customer gives written consent or if the court orders it. If the customer does not consent, a party may request *in camera* inspection. This means the court will privately review the records to determine relevance and whether portions need to be redacted. Texas codified this procedure as follows:

> (b) A financial institution shall produce a record in response to a record request only if:
>
> > (1) it is served with the record request not later than the 24th day before the date that compliance with the record request is required;

[21] *Dong v. Miller*, 16-cv-5836, 2018 U.S. Dist. LEXIS 48506, at 2 (E.D.N.Y. March 23, 2018).
[22] *Id.* at 20-24.
[23] Cal. Civ. Code § 2224 (Deering 2018).
[24] *Duffield Assocs. v. Lockwood Bros.*, LLC, Civil Action No. 9067-VCMR, 2017 Del. Ch. LEXIS 121, at 9 (Ch. July 11, 2017).
[25] *Soulos v. Korkontzilas*, [1997] 2 S.C.R. 217.

(2) before the financial institution complies with the record request the requesting party pays the financial institution's reasonable costs of complying with the record request, including costs of reproduction, postage, research, delivery, and attorney's fees, or posts a cost bond in an amount estimated by the financial institution to cover those costs; and

(3) if the customer is not a party to the proceeding in which the request was issued, the requesting party complies with Subsections (c) and (d) and:

(A) the financial institution receives the customer's written consent to release the record after a request under Subsection (c)(3); or

(B) the tribunal takes further action based on action initiated by the requesting party under Subsection (d).

. . .

(d) If the customer that is not a party to the proceeding does not execute the written consent requested under Subsection (c)(3) on or before the date that compliance with the request is required, the requesting party may by written motion seek an in camera inspection of the requested record as its sole means of obtaining access to the requested record. In response to a motion for in camera inspection, the tribunal may inspect the requested record to determine its relevance to the matter before the tribunal. The tribunal may order redaction of portions of the records that the tribunal determines should not be produced and shall enter a protective order preventing the record that it orders produced from being:

(1) disclosed to a person who is not a party to the proceeding before the tribunal; and

(2) used by a person for any purpose other than resolving the dispute before the tribunal.[26]

Canadian common-law jurisdictions provide for a *Norwich* Order, which is a form of third-party discovery order that is typically obtained where there is no extant proceeding against the defaulter. The purposes of a *Norwich* Order include:[27]

1. identifying wrongdoers (including co-conspirators and benefactors who received stolen funds);

2. finding evidence that may support an action (or determining whether a cause of action exists); and,

3. tracing and preserving assets.

[26] Tex. Fin. Code § 59.006 (2017).

[27] *GEA Group AG v. Ventra Group Co*. (2009), 76 C.P.C. (6th) 3 (Ont. C.A.); *Isofoton S.A. v. Toronto Dominion Bank* (2007), 85 O.R. (3d) 780 (S.C.J.); *Bankers Trust Co v. Shapira*, [1980] 1 W.L.R. 1274 (C.A.).

In fraud recovery, a *Norwich* order is typically used to obtain bank records of the defaulter, co-conspirators and benefactors, in order to trace funds stolen from the insured. If the funds can be traced into hard assets, those assets can then be pursued. If the funds can be traced to some other terminus point (i.e., they have been spent on things like vacations), then this evidence may play into the decision of how much to spend on pursuing the defaulter civilly.

It should be noted that a *Norwich* order is not limited to financial records, and can also be used to obtain substantive evidence to support a potential cause of action, such as Internet or telecommunications records.

One of the advantages of a *Norwich* Order is that the parties to the motion are the plaintiff and the motion respondent (typically, a bank). The alleged defaulter is not a party to the proceeding, need not be served with any of the motion materials, and will not necessarily even be aware that the plaintiff is seeking the order.

4A3. Cautions on Title / Certifications of Pending Litigation / Lis Pendens

Most states and all provinces provide for a form of caution on title to real property, where a *prima facie* claim over that property is in issue in litigation.[28] In the fraud context, this means that there is a *prima facie* case that stolen funds can be traced into real property, typically through the use of those funds to purchase property, make mortgage payments, make improvements to the property or pay property taxes. Where such a *prima facie* case can be established, a Court may grant a caution (known as a Certificate of Pending Litigation, or CPL, in Ontario). The CPL is then registered on title, and serves as notice to would-be purchasers and mortgagees that the property is subject to litigation.

A CPL provides much of the same benefit as an attachment order or *Mareva* injunction, as it effectively locks down real property pending resolution of the litigation. With a notice on title, no *bona fide* purchaser or bank will take a risk that it is not obtaining good title to the property. As the threshold for obtaining a CPL is lower than for obtaining a *Mareva* injunction (and CPL motions are often less expensive), it often makes strategic sense to go the CPL route where the asset profile indicates that the only significant assets are comprised of real property.

4A4. Criminal Restitution Orders

Courts must order defendants convicted of certain federal crimes[29] to "make restitution to the victim of the offense," per the Mandatory Victims Restitution Act ("MVRA").[30] If a carrier has compensated the victim, any restitution order must be paid to the carrier.[31]

[28] 735 ILCS 5/2-1901.
[29] This includes federal crimes that would be covered by a typical fidelity bond. For a full list of crimes, see 18 U.S.C. § 3663A(c).
[30] 18 U.S.C. § 3663A(a)(1) (2018).
[31] 18 U.S.C. § 3664(j)(1) (2018).

Most states also provide for the granting of a restitution order as part of a criminal sentence.[32] Illinois, for example, maintains a statutory framework similar in relevant part to the MVRA; both victims and carriers may have a statutory right to restitution and courts may order restitution in addition to a term of imprisonment.[33] But some states, such as California, do not entitle carriers to restitution.

Even though most jurisdictions entitle carriers to restitution, it is unwise to rely on this remedy. Restitution is often an ineffective remedy due to many defendants' inability to pay. For example, imagine a judge orders a fraudster to make restitution and serve a prison sentence. If the fraudster is unable to pay in a lump sum, the court will make a payment schedule, but the fraudster will likely earn little income while imprisoned. The Inmate Financial Responsibility Program requires inmates to work, and courts typically order half of an inmate's earnings to go toward a quarterly restitution payment.[34] However, the fraudster's periodic restitution payments will be minimal because prisoners earn only eleven cents an hour. The MVRA permits payment schedules to extend twenty years past the end of a prison sentence, but even after prison most fraudsters are unable to make full restitution.

In 2016, $110 billion in restitution was outstanding.[35] The U.S. Attorney's Office identified $100 billion of that debt as uncollectable.[36] Although there are many reasons that a debt may be uncollectable, the offender is often simply unable to pay.[37]

Asset forfeiture can make restitution more practical in some circumstances. Forfeited funds are generally deposited in the U.S. Treasury. However, the Department of Justice ("DOJ") may transfer forfeited assets to a restitution fund if the defendant cannot otherwise pay. The DOJ did this in a recent case where a doctor defrauded many of his patients. The doctor forfeited property worth about $12 million, pursuant to an order of forfeiture, and the DOJ created a plan to apply the forfeited funds to restitution for the victims.[38]

In Canada, criminal law falls within federal jurisdiction and there is one *Criminal Code* for the whole country.[39] Section 738(1)(a) of the *Code* provides for restitution orders as a sentencing option in fraud and theft cases, and section 741(1) of the *Code* provides that criminal restitution orders can be enforced civilly as if they were civil judgments. However, criminal courts have the option of making restitution orders either conditions of fulfilling sentence or "stand-alone", which means that the other elements of a criminal sentence (prison time, probation) can be "served" *without* satisfying the restitution order, and there will be no independent consequence of failure to satisfy the order, other than whatever consequences a civil court might be prepared to enforce. Anecdotally, some criminal courts make restitution orders

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[32] *See, e.g.*, 730 ILCS 5/5-5-6; *People v. Bier*, 568 N.E.2d 443, 445 (Ill. App. Ct. 1991).
[33] 725 ILCS120/4.5(c-5)(12).
[34] *Restitution*, United States Department of Justice, https://www.justice.gov/usao-wdny/restitution (Nov. 18, 2014).
[35] U.S. Gov't Accountability Off., GAO-18-203, *Federal Criminal Restitution: Most Debt Is Outstanding and Oversight of Collections Could Be Improved* (2018).
[36] *Id.*
[37] *Id.*
[38] *United States v. Fata* (In re Korff), No. 16-cv-12984, 2016 U.S. Dist. LEXIS 117534, at 7 (E.D. Mich. Aug. 31, 2016).
[39] *Criminal Code*, R.S.C. 1985, c C-46.

"stand-alone" because of the view that sentencing a person to prison time for failure to fulfil a restitution order smacks of "Debtor's Prison".

However, in a relatively recent Ontario criminal decision involving a high-profile multimillion-dollar fraud, the Court got creative. In *R. v. Waxman*,[40] the trial judge sentenced the defendant to eight years in prison and also ordered restitution in the amount of USD $15.5 million, giving the defendant three years to pay it. In the event that restitution was not made, the defendant would then be required to serve an additional six years in prison. This sentence was upheld on appeal.[41]

4B. Co-conspirators / Beneficiaries

4B1. Distinguishing between Co-conspirators and Beneficiaries

Defaulting employees often work with outside confederates in order to perpetrate fraud. For example, a procurement officer can purchase non-existent or wildly inflated goods and services from a colluding outside vendor, and then split the proceeds of the fraud. Outsiders who actively participate in employee fraud are to be distinguished from those who simply benefit from the proceeds of the fraud after the fact, without any active involvement in perpetrating the fraud. Although both classes of individuals represent potential recovery targets, the tools with which to target them are different.

4B2. Tort of Conspiracy

An outside confederate who knowingly participates in an employee fraud can potentially be liable, along with the employee, for the tort of conspiracy. Even in a situation where the outside confederate may not have been aware of all the elements of the specific fraudulent conduct of the defaulter, a finding of conspiracy may still follow where the confederate was sufficiently reckless or wilfully blind that an intention to harm the plaintiff can be inferred.

In Illinois, the tort of conspiracy has the following elements:[42]

1. A combination of two or more persons,

2. For the purpose of accomplishing by some concerted action either an unlawful purpose or a lawful purpose by unlawful means,

3. In the furtherance of which one of the conspirators committed an overt tortious or unlawful act.

Similarly, in Canadian common-law provinces, the tort has the following elements:[43]

[40] *R. v. Waxman*, 2011 ONSC 6207.
[41] *R. v. Waxman*, 2014 ONCA 256.
[42] *Fritz v. Johnston*, 209 Ill. 2d 302, 317 (2004).
[43] *Dale v. Toronto Real Estate Board*, 2012 ONSC 512.

1. the defendants acted by agreement or common design;

2. the predominant purpose of the defendants was to intentionally harm the plaintiff; and,

3. the defendants' conduct caused harm to the plaintiff.

Pleading conspiracy can be useful insofar as it may serve to increase the potential (or perceived) exposure of the outside confederate. If the confederate faces potential joint and several liability for the full amount of the loss resulting from the conspiracy, this provides the plaintiff with some leverage to either try to work out a partial repayment, and/or get the confederate to "flip" on the defaulter or other third parties, providing evidence which increases those parties' exposure. As such, where there is evidence to support the plea, the tort of conspiracy can provide significant leverage.

4B3. Benefactors — Knowing Receipt / Knowing Assistance

Those who have benefited from the proceeds of the defaulter's fraud can also be liable in certain circumstances, where they have "knowingly" received stolen property or have assisted in the disposition of stolen property.

The threshold for knowledge is different depending on whether the beneficiary has received funds or other property to their benefit, or has merely assisted in the disposition thereof, without retaining any for his own benefit:[44]

- **Knowing Receipt**: The knowledge standard for establishing liability for knowing receipt is lower, and can include, for example, recklessness or wilful blindness as to the source of the funds. Knowing receipt can be pleaded against the defaulter's spouse or third party associate of the defaulter who received funds in "questionable" circumstances, but was not a conspirator.

- **Knowing Assistance**: The knowledge standard for establishing liability for knowing assistance is higher and is, practically speaking, limited to something akin to knowledge of the source of the funds, if not actual knowledge. Typical targets include banks and investment advisors.

4C. Auditors

4C1. Auditors' Negligence / Breach of Contract Claims

When performing an audit, accountants owe a duty to their client "to use the skill, judgment and learning ordinarily possessed and exercised by other accountants under similar circumstances."[45] Clients may sue their accountants for negligence, if they breach this duty in

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[44] *Citadel General Assurance Co. v. Lloyds Bank Canada*, [1997] 3 S.C.R. 805; *Gold v. Rosenberg*, [1997] 3 S.C.R. 767; *Air Canada v. M & L Travel Ltd.*, [1993] 3 S.C.R. 787

[45] *Kemin Indus. v. KPMG Peat Marwick LLP*, 578 N.W.2d 212, 218 (Iowa 1998)

failing to discover fraud. Subrogated carriers can usually sue auditors too, but some jurisdictions require the carrier to prove that the accountants knew the carrier would rely on their work or require the suit to be brought under the insured's name.[46]

4C2. Standard of Care of Auditors

Auditors may be subject to liability if they fail to follow accepted professional standards. Auditors are not guarantors, absolutely liable for any mistake or dishonesty in a client's records, but they are expected to recognize and investigate red flags. To determine the relevant standard of care in a specific case, courts consider standards established by the American Institute of Certified Public Accountants,[47] but they are not the only standards to which accountants are held.[48] Typically, an auditor might be liable for overlooking or failing to report something like an unauthorized or improperly recorded transaction or large payment for unspecified services.

The following cases provide examples of auditors failing to meet the standard of care:

- *National Surety Corp. v. Lybrand*: Accountants audited a client's books for years but overlooked shortages of cash in the client's bank account and defalcations by an employee.[49]

- *Maryland Casualty Co. v. Cook*: Accountants failed to perform a reasonably careful audit of the city treasury.[50] Several facts — including accountants' failure to verify crude alterations to tax rolls — led the court to conclude accountants breached the standard of care.[51]

- *Stanley L. Bloch, Inc. v. Klein*: Accountants failure to personally verify inventory while conducting an audit breached standard of care. [52]

In the United States, auditors, unlike banks, generally cannot assert a contributory negligence defense.[53] A client's negligence is only a defense for auditors if it interferes with the audit.[54] Auditors may, however, change the standard of care through contract.

The law on auditor's negligence in Canada is fairly well-defined. It is not enough for an auditor to simply "tote up" the numbers in the client's records and summarize them in the financial statements; an auditor owes its client a duty of reasonable inquiry.[55] Where an auditor has the opportunity to acquire, or is exposed to, knowledge or information which might affect its

[46] *Ultramares Corp. v. Touche*, 174 N.E. 441, 445 (N.Y. 1931).
[47] Generally Accepted Auditing Standards ("GAAS") and Generally Accepted Accounting Principles ("GAAP"). *Codification of Accounting Standards and Procedures* (Am. Inst. of Certified Pub. Accountants 1972).
[48] *Kemin*, 578 N.W.2d at 217.
[49] 9 N.Y.S. 2d 554, 557, 562 (N.Y. App. Div. 1939).
[50] 35 F. Supp. 160 (E.D. Mich. 1940).
[51] *Id.*
[52] 258 N.Y.S.2d 501 (Sup. Ct. 1965).
[53] *National Surety*, 9 N.Y.S. 2d at 563.
[54] *Id.*
[55] *Capital Community Credit Union Ltd. v. BDO Dunwoody* (2000), 4 B.L.R. (3d) 1 (Ont S.C.J.) at para. 223.

audit opinion, the auditor then has a duty to probe such knowledge or information, including for evidence of fraud or other wrongdoing.[56] The Supreme Court of Canada's recent decision in *Deloitte & Touche v. Livent Inc.*[57] does not fundamentally alter the scope of the duty as between the auditor and its audit client.

Canadian law is slightly different with respect to contributory negligence, in that an auditor can assert a claim for contribution against its audit client, and auditors have even commenced claims against a client's directors for failure to adequately supervise the financial dealings of the client.

4C3. Role of Expert Evidence

A fraud victim will likely need an expert opinion to prove that its auditor should have discovered the fraud through the use of ordinary diligence. If a plaintiff asserts violations of GAAS and GAAP, the claim must, as a practical matter, be supported by an expert opinion from a qualified expert on GAAS.[58]

4D. Banks

Dishonest employees often engage in commercial paper fraud, like altering checks or forging signatures, when embezzling money. When cases involve commercial paper fraud, carriers may be able to recover from a bank. In the United States, the Uniform Commercial Code — which has been adopted by every state — and common law both provide recourse to check fraud victims (and subrogated carriers).[59]

4D1. Bank liability for Check Fraud Losses under *UCC* and Canadian *Bills of Exchange Act*

Check fraud victims have a *prima facie* right to recover loss from any bank that pays a check from their account with a forged or unauthorized signature.[60] The victim simply needs to notify the bank on time, typically within 20-30 days of the bank statement's availability,[61] and bring a cause of action within the statute of limitations.[62]

Although banks are presumed liable, they can rebut this presumption by showing that the victim failed to exercise ordinary care and contributed to the forged or unauthorized signature.[63] If the bank makes such a showing, the victim can still recover if it shows the bank also failed to exercise ordinary care.[64] This is frequently done by showing that a bank did not follow its own

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[56] *Revelstoke Credit Union v. Miller*, [1984] 2 W.W.R. 297 (B.C.C.A.)
[57] *Deloitte & Touche v. Livent Inc. (Receiver of)*, 2017 SCC 63.
[58] *Danis v. USN Communs., Inc.*, 121 F. Supp. 2d 1183, 1192 (N.D. Ill. 2000).
[59] U.C.C. §§ 3-401–4-504 (Am. Law Inst. & Unif. Law Comm'n 2002) (Only a handful of states have adopted the 2002 edition, but all states have adopted a prior version).
[60]§§ 4-401, 3,-401 3-403.
[61] The UCC allows one year, but this is usually shortened by agreement. James A. Knox, Jr. & Keith G. Flanagan, *Recovery of Loss*, *in* Financial Institution Bonds 884-885 (Michael Keeley, ed., 4th ed. 2016)
[62] § 3-118(g).
[63] § 3-406(a).
[64] § 3-406(b)

policies. If both parties share some blame, the court will allocate the loss based on the extent of each party's contribution.[65]

The UCC provides a similar framework for other types of commercial paper fraud, but the exact rules vary — even for other types of check fraud. For example, the UCC provides exceptions to banks' liability for accepting checks with forged endorsements that do not apply when the drawer's signature is forged.[66] While the nuances of recovery may vary, commercial paper fraud encompasses many fraudulent transactions and provides another recovery target: the bank. Whenever a crime of dishonesty involves a financial transaction with a third party, the carrier should explore its potential right to recover loss from the third party, especially if it is unable to recover from the fraudster directly.

In Canada, a bank can be liable for conversion when it deals with a check in a manner inconsistent with the intention of the true owner thereof (typically in employee check frauds, the drawer). Conversion is a strict liability tort. Thus, subject to certain statutory defences, when a depository bank accepts a fraudulently-drawn check, it can be liable to the drawer in conversion;[67] a forged drawer signature is "wholly inoperative" to transfer good title to the check.[68] A depository bank can also be liable where it has accepted a check bearing a forged endorsement.[69] There are certain time-based defences available to banks under the *Bills of Exchange Act*,[70] so it is prudent for a fidelity claim professional facing a Canadian check loss claim to engage counsel as soon as possible.

4D2. Bank Liability in Negligence

Although check fraud victims should turn to the UCC first, they can sue banks for common-law negligence if the UCC does not apply. For example, the Seventh Circuit has held that the UCC did not displace a bank's common-law duty to inquire whether an employee has the authority to cash checks made payable to the bank.[71] Similarly, the Eastern District of Michigan has held that the UCC did not displace the common-law duty of inquiry, which the court explained applies more broadly, including to situations that do not involve a fiduciary.[72]

Although the case law is not as well-developed in Canada, there is support for the proposition that a bank may owe a duty of care to a non-customer in certain limited circumstances to prevent fraud which will result in a loss to the non-customer.[73] As in the United States, those handling Canadian check fraud losses should first exhaust the statutory remedies under the *Bills of Exchange Act* before looking to common-law negligence as the basis of a recovery claim.

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[65] *Id.*
[66] § 3-404.
[67] *Teva Canada Ltd. v. TD Canada Trust*, 2017 SCC 51.
[68] *Bills of Exchange Act*, R.S.C. 1985, c. B.4, s. 48(1).
[69] *Id.* s. 49(1).
[70] See, for example, *id.* s. 48(1).
[71] *Mutual Service Casualty Insurance Co. v. Elizabeth State Bank*, 265 F.3d 601 (7th Cir. 2001).
[72] *Dawda, Mann, Mulcahy & Sadler, P.L.C. v. Bank of Am., N.A.*, 62 F. Supp. 3d 651, 660 (E.D. Mich. 2014)
[73] See, e.g., *Dynasty Furniture Manufacturing Ltd. v. Toronto-Dominion Bank*, 2015 ONCA 137.

5. The Next Frontier: Recovery for Social Engineering Fraud Losses

Social engineering fraud (SEF) losses have increased exponentially during the 2010s. These frauds are particularly vexing for fidelity carriers as there is typically no reasonable prospect of recovery as against the fraudster — the funds have been wired to a bank halfway around the world, and have been moved from that bank to a second bank within minutes or hours after the initial wire. Although recovery from the fraudster is not impossible (and some of the authors have had success for clients in that regard), recovery is typically not a realistic consideration in most SEF loss scenarios.

As carriers continue to pay indemnity on SEF losses, it is likely that they will look to recover against other targets. The authors raise for consideration two potential targets: business email compromise (BEC) counterparties and the insured's own bank.

- **BEC Counterparties**: Email-based SEF losses have moved from simple spoof or similar-domain name attacks to much more sophisticated attacks, involving the hacking and hijacking of legitimate email accounts and the use of those accounts to send emails designed to induce the insured to voluntarily part with funds. Where a counterparty has been "hacked" in this way, it is worth considering whether a claim might exist as against the counterparty (in tort or contract) for failure to take reasonable steps to prevent the use of its email for fraudulent purposes. It is also worth considering whether a counterparty's cyber-liability policy might respond in such circumstances. If a counterparty can be liable to its clients in tort or contract for failing to prevent system breaches which result in loss of clients' personal data, it does not seem unreasonable to extend the scope of this liability to SEF loss scenarios.

- **Banks**: Banks will typically have iron-clad client account agreements which protect them from any actions taken in reliance on the client's instructions. However, the authors have seen cases where a bank's internal fraud prevention department flagged a properly-authorized wire transfer instruction as potentially fraudulent, and alerted the client to seek confirmation that the transfer should be effected as instructed, but then released the wire transfer before the client had a reasonable opportunity to respond. Where the bank has itself determined that there are "red flags" attaching to a wire transfer instruction, a duty of care may arise to take reasonable additional steps to confirm the business validity of the wire transfer.

6. Conclusion

Through concurrent handling, judicious use of mitigation agreements, identification of potential targets and the use of specialized recovery counsel, fidelity carriers can maximize recoveries from defaulters, confederates, beneficiaries, auditors and banks. The authors hope that this paper will serve as a helpful checklist for fidelity claims and recovery professionals and their counsel to design their own "game plans" for successful recovery efforts.

Appendix: Sample Mitigation Agreement

Acme Insurance Company (the "Carrier") and American Widget Corporation (the "Insured") agree as follows:

Whereas the Carrier issued to the Insured Policy No. XY-01-55555 for the period of January 1, 2018 to January 1, 2019 (the "Policy");

And Whereas the Insured has provided the Carrier with notice of claim under the Policy, involving losses sustained by the Insured and allegedly caused by the dishonest conduct of Lawrence Larcenist ("Mr. Larcenist");

And Whereas the Insured has filed a detailed Proof of Loss dated October 31, 2018; ("Claim");

And Whereas the Carrier has commenced, but not completed, its investigation of the Claim:

And Whereas the parties to this Agreement wish to enter into a mitigation agreement giving the Carrier control over efforts to preserve recovery potential from Mr. Larcenist, and any other party complicit in, or liable for, losses sustained by the Insured from the above-referenced alleged dishonest conduct ("Agreement");

Now therefore, the parties agree as follows:

1. The Insured agrees to co-operate with the Carrier and assist it in pursuing the recovery rights including, but without limiting the generality of the foregoing:

    - to preserve all correspondence, books, records and other documents relevant to the recovery rights;

    - to make production of all such documents as may reasonably be required by the Carrier;

    - to provide to the Carrier any and all information it may have relevant to such recovery rights;

    - to provide the assistance of its employees required to pursue the recovery rights as reasonably requested by the Carrier.

2. The Carrier will have the authority to appoint and instruct legal counsel on the Insured's behalf to pursue recovery of the Insured's losses and to take any reasonable legal action deemed necessary to preserve and/or obtain recovery relating to the Claim:

3. The Carrier will fund all reasonable legal costs and expenses incurred in carrying out the

activities described in Paragraph 2;

4. The Insured shall be entitled to an accounting of the costs and expenses incurred under Paragraph 3 and not limiting the generality of this Paragraph shall be entitled to:

   A) notification each time the total costs and expenses reach the specified threshold, which shall be measured in increments of $10,000,00 (i.e., notification shall be received when the total reaches $10,000.00, $20,000.00, etc.);and

   B) advance notice of any expenditures or disbursements that may reasonably be anticipated to equal or exceed $5,000.00, in which case the Insured shall have the right to approve such expenditures or disbursements before they are undertaken, and which approval shall not be unreasonably withheld,

5. The Insured and the Carrier agree that assets or monies recovered will be apportioned as follows:

   A) The Carrier will be entitled to a first priority over any assets or monies recovered through legal action in order to reimburse the Carrier for the reasonable legal costs and expenses incurred for the activities described in Paragraph 2;

   B) After reimbursement of legal costs as called for under Paragraph 5 A) the excess of any assets or monies recovered will then be kept in the trust account of the Carrier's lawyers until the Carrier takes a position on whether the forthcoming Claim for the alleged dishonest conduct of Mr. Larcenist is payable under the Policy. Those recovered assets or monies will then be apportioned between the Insured and the Carrier as per Section [●] of the Policy.

6. The Insured agrees that should it be determined that no claim is payable under the Policy, then the Insured will reimburse the Carrier for all reasonable legal costs and expenses incurred, as referenced under Paragraph 2, less any reimbursements paid under Paragraph 5;

7. The Insured shall save and hold harmless the Carrier and/or any of Its present or former directors, shareholders, partners, principals, officers, employees, agents, trustees, attorneys, reinsures, parents, subsidiaries, affiliates, divisions, managers, representatives, predecessors or successors, partnerships, corporations, parent corporation(s) and their respective administrators, successors and assigns from any liability of any kind stemming from any action undertaken in good faith, and in a non-negligent manner, within the scope of this Agreement;

8. The Insured agrees that the Carrier can withdraw from this Agreement for any reason and following reasonable notice by the Carrier. If the Carrier does so withdraw, then all legal costs and expenses incurred to the date of the withdrawal will be for the account of the Carrier. The hold-harmless provided by the Insured in Paragraph 7 will survive the withdrawal and continue indefinitely past the date of the withdrawal;

9. The Carrier agrees that the Insured can withdraw from this Agreement for any reason and following reasonable notice by the Insured. If the Insured does so withdraw, then all reasonable legal costs and expenses incurred to the date of the withdrawal will be for the account of the Insured. It is further agreed that any withdrawal by the Insured will not prejudice its right to advance the Claim;

10. The Carrier and the Insured agree that neither party will retain counsel appointed under this Agreement to act or give advice on any coverage issues or disputes that may arise from the Claim.

11. In the event that Mr. Larcenist brings a wrongful dismissal or other employment-related action or proceedings against the Insured, the Insured retains the right to appoint counsel of its choosing to represent it in such action or proceedings;

12. The parties agree that all information obtained under this Agreement shall be shared with both parties, whether or not the Claim is made and/or approved, and whether or not either party exercises its right to withdraw from this Agreement;

13. This Agreement does not and shall not be deemed or construed to constitute any acceptance or acknowledgement of any liability on the Carrier's part for the Claim, or a waiver of either the Carrier's or the Insured's rights under the Policy; and

14. This Agreement may be executed in counterparts by the parties hereto with the same effect as if the signatures were upon the same instrument. Each counterpart will be deemed an original, which, taken together, shall constitute a single instrument.

Dated ____________________________

By: ___________________________
Acme Insurance Company
Position: _______________________

Dated ____________________________

By: ___________________________
American Widget Corporation
Position: _______________________

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Cal. Civ. Code § 2224 (Deering 2018)

Fla. Stat. § 76.12 (2018)

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