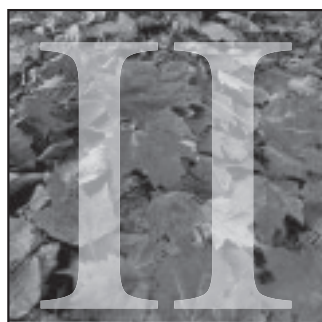

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Editor's Note: This article discusses issues that were addressed in a teleconference, "Fraud Prevention and Investigation Issues," presented on September 16, 2010 by MDTC's Commercial Litigation Section.

Responding to Workplace Embezzlement and Asset Misappropriation – A Legal and Forensic Accounting Guide

By: Edward P. Perdue, and Christina K. McDonald, Dickinson Wright PLLC

The authors acknowledge and thank Jeffrey L. Johnston and Robert J. Wagman, Jr. for their expertise and input with this article.

Executive Summary

Workplace fraud is a common occurrence and employers must exercise care both to prevent it and to properly investigate it when it does happen. The most important prevention tool is to set a "tone at the top" that unethical conduct will not be tolerated and that encourages employees to report improper conduct.

When fraud occurs, the company should move quickly, under the supervision of an investigating attorney, to preserve the evidence relating to the fraud, and may also want to involve a forensic accountant in the investigation. The investigation must be conducted in such a way as to avoid impairing coverage under any applicable insurance policies. If the fraud is financial the company should also retain an independent examiner to conduct the investigation, because a government investigation is almost certain to follow.

Introduction

As the national economy continues to suffer, business owners have taken drastic actions to keep their doors open; job cuts, salary and benefit reductions, and cost controls are only a few of the options business owners must consider to succeed in the current economic climate. These conditions create an environment conducive to increased employee theft and fraud in the workplace. There is a basic explanation for this – employees have lost hours and benefits (and their spouses have lost jobs) and they are under financial pressure. This creates strong incentives for employees to make up these losses by taking cash and other assets from their employers.

The typical business organization loses 5% of its annual revenue to employee fraud. That equates to roughly \$2.9 trillion per year on a global basis.¹ Asset misappropriation is the most common type of workplace fraud, making up about 90% of cases.² According to one source, a shocking 75% (yes, three out of every four employees) of the global workforce will commit workplace fraud at least once, and of those who do steal from their employers, half will steal repeatedly.³

The term "employee fraud" encompasses two⁴ basic types of theft committed by employees: financial statement fraud and asset misappropriation.⁵ In the post-Enron era, financial fraud (so-called "cooking the books" or corruption) spurred the implementation of new reporting and financial compliance requirements and other prevention measures. Asset misappropriation, on the other hand, occurs when an employee steals a company's cash or non-cash assets for the employee's own personal use. While asset misappropriation is less costly per instance than financial fraud,⁶ the sheer number of instances of asset misappropriation makes it severely damaging to business organizations of all sizes.

A business is at the greatest risk of employee fraud when three conditions are present: motivation, opportunity, and rationalization.⁷ When employers are forced to make the workplace a less pleasant place because of economic constraints, employees are faced with the motivation and rationalization needed to commit workplace theft. Given the opportunity, a jilted employee is more likely than not to commit fraud. Small firms and organizations are the most susceptible to workplace fraud because the opportunity to commit fraud is more prevalent.⁸ No matter the size of the organization, employee fraud occurs at all levels—from the CEO to the hourly employee. Losses are generally commensurate with the employee's level of pay and responsibility.



Edward Perdue is a partner in the Grand Rapids office of Dickinson Wright. He focuses his practice on sales disputes and also has extensive experience with commercial fraud and embezzlement cases. His email address is eperdue@dickinson-wright.com.



Christina McDonald is an associate in the Grand Rapids office of Dickinson Wright. Her practice areas include commercial and business litigation with a focus on real estate and construction. Her email address is cmcdonald@dickinson-wright.com.

RESPONDING TO WORKPLACE EMBEZZLEMENT AND ASSET MISAPPROPRIATION

While asset misappropriation is less costly per instance than financial fraud, the sheer number of instances of asset misappropriation makes it severely damaging to business organizations of all sizes.

In this article, we address how to deal with workplace fraud when it happens: how to investigate instances of employee fraud and how to prevent it from occurring in the first place.

Prevention

Benjamin Franklin coined the famous phrase “an ounce of prevention is worth a pound of cure.”⁹ That phrase absolutely rings true when it comes to preventing employee theft. By spending time and resources to prevent fraud up front, businesses can avoid huge future losses. Forensic accountants can help implement specific measures to prevent misappropriation and fraud by examining a business’s processes and procedures (*e.g.*, conduct periodic inventories of high-value items frequently, investigate financial discrepancies, invest in software security, and the like), but perhaps the most important measure that can be taken to prevent occupational fraud is the “tone at the top” set by business directors and managers in the workplace.

When management promotes ethical awareness at the workplace and deals with instances of fraud and misconduct quickly and directly, employees will know that misappropriation of corporate assets is not tolerated and will be encouraged to report instances of suspected fraudulent conduct. In fact, the most common way that employee fraud is detected and discovered is through reports by co-employees (49.2% of discovered thefts are uncovered through

employee tips).¹⁰ Hotlines, management review, internal and external audits, and communication with customers and vendors are all good ways to detect and prevent fraud from occurring.

Another way to minimize the effect of workplace fraud is to be aware of common indications that employee theft may be occurring and practicing early intervention. Signs that an employee may be committing fraud include: living beyond their means; experiencing known financial difficulties; unusual control issues including an unwillingness to share duties and working nights and weekends; not allowing co-employees to process work for them; exhibiting unusually close associations with vendors or customers; suffering from severe divorce or other family problems; and having a bad attitude toward their supervisors and management.¹¹ In addition to implementing procedural safeguards, advising businesses to watch out for these signs may help to minimize employee theft.

Employee theft will occur in almost every business. The ability of a business to prevent and detect fraud is greatly enhanced when the company’s principals provide active oversight. At the most fundamental level, a small business owner should receive unopened bank statements so he or she can review them for suspicious transactions. Moreover, the principals need to ensure that they understand the company’s revenue and expense streams so they have the ability to detect unusual trends. Business owners should be advised to carry adequate

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Preserving the evidence of potential employee theft is a critical first step in any investigation.

theft protection insurance and to consult with their accountants on a regular basis to implement internal mechanisms designed to avoid fraud.

Investigation

When a business owner or manager learns that one of her employees may be stealing from the business, one of her first calls made should be to the business’s attorney. When an attorney becomes involved after an asset misappropriation allegation is made, he should ensure that the business properly preserves all evidence, prepares for and assists in the investigation, and knows when to contact the appropriate authorities.

Preserving the Evidence

Preserving the evidence of potential employee theft is a critical first step in any investigation. The investigating attorney should work directly with the accused employee’s supervisor or the business’s management team to determine who has control of the information sources that will be examined during the investigation. The second step is to determine who within the business is in the best position to be in control of the investigation internally; this requires making a list of all persons with administrative control over documents, hardware, software, video monitoring, e-mail communications, and telephone records. An employee’s supervisor may be in control of the investigation, but should not investigate the claim if the supervisor detected or discovered the theft (*i.e.* if the supervisor is also the accusing party).

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Once the appropriate investigation team is assembled, it is essential to implement a system for preserving documents, records, and internal business processes. This may require moving files for safekeeping, locking e-mail accounts and electronic document storage files, and the like. Every internal process that could potentially be affected by the theft should be documented for a more in-depth examination to be conducted after all evidence has been preserved. Businesses must quickly preserve evidence to maintain the integrity of the evidence, prevent the destruction of evidence, and to prepare for further investigation to follow as soon after the theft as possible.

After vital information has been preserved, the attorney should contact the business's theft insurance agency or insurance representative. No action should be taken in the investigation until it is clear that the company's rights to receive reimbursement under any applicable insurance policy will be preserved. Often agencies require specific procedures for dealing with instances of employee theft, and counsel should carefully review the notice and reporting procedures set forth in all applicable policies.

Next, the investigating attorney should identify potential witnesses. The investigating attorney and internal investigator should speak with the manager who is directly impacted by the loss as soon as possible. The investigating attorney should stress the need for privacy and confidentiality during the early stages of the investigation. The manager should be able to help identify the employees at every level of the company who had access and an opportunity to commit the theft as well as those employees who may have known about the theft but did not report it. Witnesses who may be unavailable later or who are at risk of forgetting important information should be interviewed as soon as possible.

If a particular employee is targeted during the preparation phase, it may be

Businesses must quickly preserve evidence to maintain the integrity of the evidence, prevent the destruction of evidence, and to prepare for further investigation to follow as soon after the theft as possible.

advisable to put the accused employee on administrative leave during the investigation. This further ensures that all vital documents and evidence, including electronic files, will be preserved. It also helps maintain employee morale and prevents unnecessary and undesirable social effects on the accused.

Preparing for the Investigation

After the necessary information has been preserved, the investigating attorney should prepare for the investigation. First, a reporting relationship with the company needs to be established. If the attorney is conducting the investigation, the attorney needs to know to whom information should be reported. The investigating team member may be the contact, but often it is advisable to have a special investigation committee established to handle internal fraud investigations. If financial fraud is suspected, the

If financial fraud is suspected, the company or board of directors should immediately retain an independent examiner to conduct the investigation and prepare for the government investigation, which will almost certainly follow.

company or board of directors should immediately retain an independent examiner to conduct the investigation and prepare for the government investigation, which will almost certainly follow.

Depending on the nature of the fraud, the attorney should consider whether to call the company's Certified Professional Accountant ("CPA") or an outside forensic accounting specialist to assist with the investigation. The company's CPA could potentially have exposure even though an annual financial statement audit or review is not primarily designed to detect fraud. Moreover, traditional CPAs do not necessarily possess the analytical and forensic skills required to perform a proper fraud investigation. These skills involve forensic procedures to systematically gather evidentiary data through the use of recognized investigation techniques that can be presented in a court of law, if necessary. Depending upon the circumstances of the asset misappropriation, it may also be appropriate to hire an outside investigator or even an undercover investigator.

An investigating attorney must be involved in preparing for the investigation of the asset misappropriation. First, attorney involvement affords a corporate client the protections of the attorney-client privilege. Second, the attorney is in the best position to map out the investigation process using the information that has been preserved. Before information is lost or handled, the investigating attorney should review the evidence the client has gathered at the close of the preparation phase. Without a plan, potential witnesses and evidence can be lost, obstructing the company's potential recovery.

After preparing a plan, an investigating attorney will conduct interviews and, if the situation warrants, contact the appropriate law enforcement officials.

Employee Interviews

Employee interviews are critical when investigating workplace theft. However,

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employee interviews come with their own set of stumbling blocks and should not be conducted without an understanding of applicable employment law principles.

All employees have a reasonable expectation of privacy in the workplace. In an employment setting, what constitutes a “reasonable” expectation depends upon the workplace environment and the policies in place in an employee handbook or elsewhere. Invasion of an employee’s reasonable expectation of privacy can leave the company liable to a civil lawsuit. For example, if an employee has a locker at the workplace and supplies his or her own lock, that employee has a greater expectation of privacy with respect to the contents of the locker than would an employee whose lock and combination are supplied by the employer. In a public employment setting in which an employee has a reasonable expectation of privacy in their work area, the internal investigating team should contact law enforcement officials and obtain a search warrant prior to making a physical investigation of the employee’s work space. Privacy factors should be assessed anytime a company wants to make a physical investigation of the employee or his or her work area.

When conducting a sit-down interview of an employee, an attorney, especially in-house counsel, should always warn the employee that the company does not, and in-house counsel cannot, represent individual employees. The investigating attorney may choose to advise the employee who is being investigated for allegations of theft of the right to retain his or her own counsel.

In union work settings, it is especially important to adhere to employee rights when conducting an interview. Collective bargaining agreement procedures must be followed. Union members are often allowed to have another union member or co-employee present during any interview at which evidence may be discovered that could potentially lead to a rep-

Employee interviews come with their own set of stumbling blocks and should not be conducted without an understanding of applicable employment law principles.

rimand or termination. Even in non-union work settings, it may be advisable to have a co-employee present during any informal investigations. If a second employee is not present (which may be a more prudent option in some circumstances), it may be advisable to have a paralegal, second attorney, or other member of the investigating team present. The presence of paralegals and multiple attorneys serves to protect privilege.

An attorney conducting an interview should also be mindful not to create an intimidating situation that could lead an employee to feel trapped. Allegations of false imprisonment can be avoided by having a co-employee present during the investigation, having the investigation in an open-door setting, and advising the employee that he or she is free to terminate the interview at any point. Again, the employee should always be advised that they have a right to have legal counsel present during an investigation interview.

At the close of the interview, it is recommended to obtain the employee’s signed, written statement if at all possible. The signed statement has the advan-

Even in non-union work settings, it may be advisable to have a co-employee present during any informal investigations.

tage of being one of the statements made closest in time to the actual incident. It serves as a record in light of relevant questions. However, it’s important to assess the likelihood that the witness’ statement may be discoverable in any future litigation. If there’s a possibility that the company may also be accused of fraud, obtaining a witness statement later in time (after more facts have been developed) may be a safer course of conduct. Generally, fact witness statements are extremely helpful during any potential prosecution or reprimand of the offending employee.

Follow-Up

When an employee investigation reveals that a particular employee has misappropriated company assets, the company must decide how handle the theft. A company could issue an internal reprimand, file a civil suit for damages, or contact law enforcement officials to conduct a criminal investigation and prosecution.

Internal employee reprimands must be consistent with stated company policies and cannot violate any applicable laws. Depending on the severity of the misappropriation, the company may choose to terminate the employee. A company may also file a civil suit for damages, including restitution, of the amounts stolen.

Involving law enforcement officials can also be a good way to handle asset misappropriation. Law enforcement officials can be contacted at any time to take over an investigation, but it may be helpful to wait and present law enforcement officials with evidence of embezzlement so that they can proceed appropriately. As a part of any criminal investigation, prosecution and sentencing, the company should seek restitution of the amounts stolen, including in any plea bargains that are offered to an accused employee.

The company may also want to consider creating an internal press release. Corporate action to thwart and handle instances of employee theft can serve as

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an effective deterrent. Employees who know their employer is serious about handling fraud are less likely to commit it.

After any instance of employee fraud, the company should consult with their accountant on maintaining and improving best practices in the future to avoid more instances of fraud and misconduct.

Conclusion

The best way to handle employee theft in the workplace is to prevent its occurrence. When it does occur, enlisting the help of a forensic accountant and an

attorney can help a company navigate through the investigation and punishment of an offending employee and help obviate the opportunity for a second occurrence.

Endnotes

1. Association of Certified Fraud Examiners, *2010 Report to the Nations on Occupational Fraud and Abuse* (2010), available at <http://www.acfe.com/rtnn/rtnn-2010.pdf> [hereinafter "Report"].
2. *Id.* at 4.
3. *Id.*
4. There are other types of workplace fraud, but those (including corporate corruption) are beyond the purview of this article.
5. *Report* at 4.
6. The median loss per instance of asset misappropriation is \$135,000. *See id.*
7. Sometimes the formula is delineated as pressure, opportunity, and rationalization. *See, e.g., Navigating the Minefield in the Economic Downturn: Financial and Legal Lessons from the Trenches*, Metropolitan Corporate Counsel (Northeast Ed., Jan. 2009).
8. *Report*, at 5.
9. <http://www.ushistory.org/franklin/quatable/quote67.htm>.
10. *Employee Theft: 10 Strategies to Help You Thwart Fraud Schemes*, 10 Institute of Management & Administration: Security Director's Report (Oct. 2008)
11. *Report* at 73.



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GREG POLLEX CFP
GPollex@ringlerassociates.com
Certified Financial Planner (CFP)

248-643-4877
fax **248-643-4933**



RACHEL GRANT CSSC
RGrant@ringlerassociates.com
Certified Structured
Settlement Consultant (CSSC)

248-643-4877
248-643-4933 *fax*

www.ringlerassociates.com