

the MANAGER



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Employee Dishonesty

Municipalities are increasingly being affected by acts of employee dishonesty. Many such losses are treated internally, and the public is never made

aware of them. Insurance claims and police reports aren't filed. Recently, however, a number of insureds have made claims against their insurance policies, and the losses have not been insubstantial.

Many acts of employee dishonesty are cleverly designed and shrewdly carried out.

One person who has explored this issue, especially in Massachusetts, is Frank Colvario, co-owner of Consulting Partners, Inc., of Charlestown, MA. Although every case is unique, Mr. Colvario has observed that the most common causes of employee dishonesty are adverse habits such as living beyond one's means, drug and alcohol addiction, sexual exploits, and extensive gambling, or some variant thereof. Other drivers are huge family health bills, education expenses, greed, revenge, and court-mandated payments – such as divorce settlements or child support.

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Government Crime Coverage Form

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The Government Crime policy is a named peril policy.

There are eight insuring agreements in the policy, and each may have its own

limit of insurance. For a crime to be covered under the Government Crime Policy, there must be a loss to the municipality or other government entity arising from:

Theft or robbery, committed by an employee, of currency, travelers checks, money orders, securities, or

other tangible property with intrinsic value. The first insuring agreement has a Per Loss Coverage limit; the second agreement has a Per Employee Coverage limit. The theft of personal checks isn't included as an insurable loss under the crime policy.

Forgery or alteration of checks or written promises to pay a third-party. Forgery doesn't include a person's own signature.

Loss of money or securities from inside the premises of the insured or a bank. A loss may be caused by theft, disappearance, or destruction. Damage to the insured's

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FREE

Boiler Maintenance Workshops

FREE

Massamont Insurance Agency is co-hosting a workshop with Hartford Steam Boiler Inspection and Insurance Company. This seminar concerns Boiler Maintenance and Safety for the Physical Plant Operator and it is offered in five locations throughout New England from Cheshire Connecticut to the Canadian border in Houlton Maine. Send your Boiler Maintenance people to one of these free workshops. All information as well as registration can be found at:

http://metrogard.com/Seminars/HSB_Boiler/boiler_maintenance.htm, or call 800.444.3916 x633

Seminar location	State	Date (9:30 am - 3:30 pm)	Speaker	Sponsoring local Agency
Town Hall 100 Maple Ave Shrewsbury MA 01545	MA	Tuesday, October 4	Jim Desisto	Bralely Wellington Insurance
Houlton High School 5 Bird Street Houlton ME 04730	ME	Wednesday, October 5	Kevin Smith	F.A.Peabody Insurance
H. D. Segur 56 Knotter Drive Cheshire CT 06410	CT	Thursday, October 6	Dan Werkheiser	H. D. Segur Insurance
Barrington Middle School #85 Route 9 Barrington, NH 03825	NH	Wednesday, October 12	Jim Desisto	Immanuel Insurance
Gardiner Middle School 161 Cobbossee Ave. Gardiner, ME 04345	ME	Thursday, October 13	Kevin Smith	Kyes Insurance

Workshops last from 9:30am to 3:30pm. Coffee and baked goods will be provided; lunch is "on your own."

Would you like to be on our mailing list?

Want more info on our programs? Contact:

Hugh Campbell

Massamont Insurance Agency, Inc.
800.444.3916 ext 632

email: hcampbell@massamontinsurance.com

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Losses usually occur when there is opportunity and few if any executed procedures, checks and balances, or thorough audits, according to Mr. Colvario. Where there are few controls, employees defrauding the municipality or school district often get away with it for years.

Examples of Municipal Employee Dishonesty

☛ **Employee theft is often associated with the handling of cash and checks.** In a Massachusetts case, a school district secretary stole close to a half million dollars over a ten-year period. The town was able to recover about \$111,000 from its most recent crime insurance policy – the amount of the employee theft during the three-year term of the policy. No employee dishonesty insurance coverage was in place to cover prior losses.

The employee, whose annual wages were close to \$20,000, handled about \$250,000 annually in cash and checks for her employer. By taking about \$40,000 each year for herself, she tripled her annual income. Since the revenue that the school actually received – net of the theft – didn't vary much from year to year, the employer never became suspicious; and her theft was never detected. Yielding to her conscience, she recently made an unsolicited confession to her employer and to the local police.

☛ **A Massachusetts school superintendent, whose annual income was more than \$100,000, created a fictitious company for the purpose of committing fraud.** That company had no employees, no property address, and no corporate tax identification number. For several years the superintendent prepared phony contracts with and wrote false purchase orders to the fictitious company for supplies and equipment. The company then billed the school system; and the

superintendent authorized the payments, which totaled \$366,677, according to the local district attorney. No supplies or equipment from the company were ever received by the school. Furthermore, the school reimbursed him an additional \$53,986 over the years for expenses he falsely claimed he personally incurred on behalf of the school. The superintendent was eventually caught, and in 2003 he was sentenced to four to five years in state prison on the 56 counts of larceny, to be followed by ten years probation. He was ordered to pay \$420,663 in restitution.

☛ **In another case an assistant manager, using official purchase orders, went to local stores and bought appliances and computer equipment at discounted prices. He then pawned the goods and pocketed the proceeds.**

At a local golf club he made purchases for what was purported to be a fund-raiser; but he got caught when the club called his employer and casually mentioned what the club thought was a legitimate, authorized charitable event. Upon discovering the charity fraud, the employer immediately instituted an investigation, which uncovered about \$150,000 in various fraudulent activities. The employee failed to comply with court orders regarding restitution and was incarcerated. This incident convinced the employer to look into other business practices, which led to the discovery of another manager who was found to be involved in bid rigging. He agreed to make restitution.

☛ **Collusion between a contractor and an employee, especially a trusted employee with purchasing authority, can lead to substantial losses.** A Massachusetts town uncovered a scam

Employee dishonesty often involves collusion with other parties.



Fee for service arrangements are often safe targets for employee theft and fraud.

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that was initiated by the town's sewer superintendent and a managerial employee of a contractor that operated the town's sewer facility. As part of the agreement with the contractor, the town performed some sewer system project-related services for which the contractor reimbursed the town. The contractor wrote checks for project-related expenses, payable to the town, the sewer superintendent, and the sewer commissioners.

In the course of business, project-related expenses were identified by the sewer superintendent and approved for money transfer by the contractor's regional district manager. Upon receiving the checks, the superintendent simply deposited the checks in one of his personal bank accounts. Besides a town account that the superintendent had set up at a local bank, he and the contractor's project manager also established a joint personal account there.

Eventually the town administrator became suspicious, and the town accountant discovered discrepancies related to the contractor. The selectmen decided to conduct an audit of the sewer department.

The scam began to unravel in May 2002 when a cooperative bank in a neighboring community reported to local police that the superintendent had deposited a \$5,700 check made payable to him, the sewer commissioners, and the town into his personal account. The municipal police chief was notified, and a criminal investigation was initiated. Police detectives initially found about \$200,000 in illegal bank deposits. The

police chief's professional instinct told him overall losses might be considerably more. The magnitude of the fraud was further exposed when the town's auditors determined that more than \$300,000 had been embezzled between 1997 and 2002.

Both managers pleaded guilty in court. In September 2004 the superintendent was ordered to make restitution to the town in the amount of \$168,827, serve 18 months in prison, and undergo psychotherapy and drug counseling. The contractor's regional district manager was ordered to make restitution of \$165,656.

In January 2005 the town sued the local bank in state court for its alleged negligence regarding the accounts used in the scam. According to the suit, the bank:

- Allowed the superintendent and the contractor's regional district manager to open a town checking account at the bank with exclusive check writing authority and without authority from the town.
- Arranged to have bank statements mailed to a residential apartment in Boston, not to town hall, thus hiding the fraud.
- Had very lax and deficient fraud detection and oversight procedures, so weak that the bank never detected the unlawful activity committed by the superintendent and the contractor's regional district manager.



➤ A town clerk in New Hampshire was charged with theft of over \$200,000. The missing funds came from vehicle registrations, marriage licenses, and other fees collected by her office. The alleged thefts took place over an 18-year period.

➤ A landfill employee sold hundreds of stickers to contractors, charging them \$200 each. What the contractors got were residential permits worth \$25

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Government Crime Coverage Form, cont'd from page 1

premises may also be covered if the damage is related to a theft or attempted theft.

❑ A robbery or attempted robbery of tangible property of value from an employee (other than a watchman or janitor) inside the premises of the employer or a burglary of property of value from a safe or vault. Damage to the premises, a safe or vault may also be covered.

❑ A loss of money or securities outside the insured's premises while in the care and custody of a messenger or armored car service, including disappearance and destruction.

❑ The use of a computer to fraudulently transfer money, securities, or property of value from the insured's premises or from a banking facility.

❑ Money orders or counterfeit currency acquired during the regular course of business. The Government Crime Coverage Form doesn't cover bad checks or overdrafts.

Affixing the "Add Faithful Performance of Duty Coverage" endorsement will enhance the crime policy. This stipulation provides for a loss of money, securities, or other property that results from the failure of any employee to faithfully perform assigned duties. Together with the employee theft insuring agreements, these provisions provide coverage for most losses due to employee dishonesty.

For purposes of the crime policy, employees are considered part of the workforce for the duration

of their employment and for thirty days after termination of employment. The term "employee" includes any person who is temporarily hired to meet short-term needs, such as a seasonal worker or a substitute for a permanent employee who is on leave. Note: There is no coverage for a temporary employee who has custody of property off premises (unless the basic policy is amended to provide such coverage). Special rules apply to employees, managers and trustees of employee benefit plans. The crime policy doesn't provide coverage for employees of leasing firms and independent contractors.

Not all criminal acts or acts of employee dishonesty are covered. For example, under the employee-theft insuring agreements, there is no coverage for treasurers, tax collectors, or employees who are required by law to be individually bonded. Generally, there is no coverage for vandalism, malicious mischief,

extortion, vehicle damage, fire, arson, assault, intentional injury to a person, making false statements on employment applications, or identity theft though there may be coverage for some of these exclusions under the employee-theft insuring agreements. Some of the excluded losses are covered in other insurance policies, e.g., the general liability, auto, or fire forms. The crime policy excludes coverage for accounting or arithmetical errors resulting in losses under three of the insuring agreements for theft and robbery. Indirect losses, e.g., inventory shortages determined solely by an inventory computation, aren't covered under the employee theft or computer fraud insuring agreements.

Generally, theft, robbery, embezzlement, forgery, counterfeit currency, and fraud are covered in the Crime Policy.

Employee Dishonesty, cont'd from page 4

each. The town employee pocketed the difference. The town not only lost \$175 for each permit, it feared that some of the waste dumped might not have met town and state landfill requirements.

☛ A housing authority employee in Southeastern Massachusetts pocketed fraudulent fees that she charged several residents for Section 8 low-income housing vouchers. Victims were charged as much as \$6,000. They were told that this was necessary to get the vouchers, and that the fees were for a security deposit and the first and last month's rent. The government doesn't charge fees for housing vouchers under Section 8. The employee was fired and charged in 2005 with the corrupt receipt of payments related to a federally funded program, a criminal offense. Although this is an example of employee dishonesty, it is not an insurable event as there was no loss to a government entity. But the case does illustrate how easy it is to commit defraud when in a position of trust.



☛ In central Massachusetts, a city employee received a 4-month sentence, 100 hours of community service, and a \$5,000 fine in federal court for swindling the school department of \$10,000 in fees. The former manager of the school lunch program had vendors in charge of school-placed soft-drink vending machines write checks payable to him instead of the school department, then signed the checks and pocketed the funds.

Loss Control for Municipalities

A municipality's policies and procedures may not only be insufficient but inadequately executed,

according to Frank Colvario. To be effective they must be comprehensive, clear, actively implemented, and dynamic.

There should always be a segregation of financial duties among employees. Internal controls need to be sufficiently prepared, dutifully executed, and reviewed by outside auditors. They must be updated as situations change. Missing or questionable information on purchase orders should raise a red flag, and possibly trigger an audit.

An employee's lifestyle, if out of sync with the family's known income, should trigger a review or investigation. The municipality's staff may keep silent, even if suspicious, in their disbelief that a fellow employee could commit an act of betrayal of the town or school district, and the staff.

Audits may be performed, but they must be thorough if the auditors are to have a high probability of detecting fraud and embezzlement. Audits of internal controls, policies, procedures, and practices of many entities are inadequate or non-existent. To be effective, the audit must be well designed, adequately funded, and professionally executed. Auditors and audit style should be changed every few years.

While minor losses are typically handled internally, other losses may result in insurance claims under the **Government Crime Coverage Form**.

According to Mr. Colvario, the optimum loss prevention strategy is a combination of exemplary (best) business practices; enforced policies and procedures; an ethical business culture; attentive fellow employees; and sound, thorough, and comprehensive audits that include financial reviews as well as audits of internal practices and controls. In light of the number of recently revealed acts of

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employee dishonesty, many municipalities may need to take additional steps to detect and curtail employee losses.

The following are some practical tips that municipalities and other government entities can use to curtail employee dishonesty. Massamont's Underwriting, Claims, and Loss Control staffs can help you with other suggestions.

- ✓ Financial policies and procedures should be drafted in detail, updated periodically, and comprehensively enforced.
- ✓ Signing authority in all matters should be affirmed to employees in writing.
- ✓ Executives should be attentive to conflicts of interest.
- ✓ As a matter of segregation of duties, no one person should have control of the check writer, the signature stamp, and the cancelled checks.
- ✓ Managers shouldn't sign invoices or employee expense accounts without first determining necessity and accuracy.
- ✓ Missing or questionable information on financial documents should raise a red flag, and, possibly trigger an audit.
- ✓ Internal or external accountants shouldn't pay invoices or expense accounts unless they are properly signed.
- ✓ Two signatures should be required on checks written over some nominal amount.
- ✓ Employees should be encouraged to report suspicious activity.
- ✓ Auditors should verify the delivery of goods and services and payments made.
- ✓ Auditors should randomly contact parties that might have obligations to pay the municipality or school district monies for activities and services – e.g., rentals, leases, cell tower fees, business reimbursements, equipment and supply rebates, or other

commitments – to determine what was paid and that the payments were properly deposited.

- ✓ Management should hire professionals to conduct a thorough investigation if there are signs of dishonesty, theft, fraud, or embezzlement.
- ✓ Auditors and audit style should be changed every few years.
- ✓ The recovery of losses from and the subrogation of insurance claims against third parties may be possible if they were negligent or were in collusion with a felon employee.

Horror stories abound, and not just in New England. They come from Long Island, Miami, New Orleans, California, and elsewhere. Several reported cases exceed \$1 million.

Our sincere thanks to Frank Colvario for graciously sharing his experiences with us on several employee dishonesty cases with which he has been involved as he assisted clients in an investigative and review capacity, and for his insight on loss prevention.

Frank Colvario, a former school business administrator and long-time financial consultant, has investigated many employee dishonesty situations involving municipalities and schools. Mr. Colvario has helped with financial, insurance, managerial, and employee benefits research, analysis, investigations, reporting, and solutions for two decades. Mr. Colvario has saved his clients hundreds of thousands of dollars, and helped them generate revenues and recover monies lost through employee dishonesty and fraud. He represents several insurance companies and insurance agencies, including Massamont Insurance.



Internal controls, alert employees willing to report irregularities, and proficient audits – including audits of internal controls – are the main weapons against employee theft, embezzlement, and fraud.

Government Crime Coverage Form, cont'd from page 5

Legal expenses are covered only for cases involving forgery, and only with the written consent of the insurer. The crime policy doesn't cover losses from acts of dishonesty perpetrated by a named insured.

Importantly, there is exclusion in the crime policy for any employee once it is discovered by the insured (or an official of the insured not in collusion with the employee) that the employee has committed a theft or other act of dishonesty while in the insured's employment or prior to hire. There is exclusion for employee theft caused by any employee for whom prior insurance was cancelled and not reinstated.

In the event there is an actual loss, the terms of the insurance policy will govern. This article only provides a brief overview and not specific definitions or a detailed explanation of the policy.



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Schools***

Note: Any coverages described in this newsletter are summarized and subject to terms, conditions and exclusions printed in policies. References to specific policy language, terms or conditions should not be construed as binding. Refer to policy forms for specifics on the coverages and limits. All coverages are subject to state law, which may vary materially from the stated information.