COVERING A BUSINESS BEYOND THE BASICS

Contractors can use fidelity insurance to protect against the risk of heavy losses because of employee theft.

By Robert J. Duke

Construction is a risky business. The probability of a contractor that exists today being out of business 2 years from now is astoundingly high. According to BizMiner, of the 850,029 construction companies in business in 2004, 649,602 were still in business in January 2006, a 23.6-percent failure rate. Approximately 22 percent of construction companies that were in business in 2005 were out of business in 2007.

Risk drivers, such as inadequate estimating, poor site conditions, labor shortages, and materials price increases, affect the contractor's exposure to risk. In addition, the contractor must address the risks that affect all businesses, such as perils to the contractor's property and exposure to third-party liability claims. These risks typically are addressed by purchasing insurance. Contractors also incur significant losses caused by theft and dishonesty. The risks related to theft of the contractor's property—particularly theft by the contractor's own employees—often are overlooked, leaving the contractor's assets exposed to heavy losses. This article addresses how a contractor can handle the risk of employee dishonesty through fidelity insurance.

UNDERSTANDING THE RISK

Employee theft is a risk that affects all businesses. Studies and commentary regarding the cost of employee theft peg annual costs at approximately $50 billion.[1] (This figure was noted in 2002. Certainly, it is quite likely that employee theft losses now well exceed the $50-billion mark, especially when today's rough economic times can be the justification for an employee stealing from his or her employer.) The Association of Certified Fraud Examiners estimates that the median loss for "asset misappropriation" is $150,000.[2] Of course, losses have exceeded this figure into the millions of dollars.

For example, a former manager of Microsoft recently pleaded guilty to embezzling nearly $1 million from her employer. Such losses could destroy any capital and liquidity of a business, and could cause a business to fail. Thus, the risk of employee theft is real. Just as a business purchases property insurance to cover the risks of fire, a business should purchase fidelity insurance to cover the risk of employee theft. In addition, the business should establish sound internal controls to serve as a first line of defense to thwart and detect dishonest schemes by employees.

INTERNAL CONTROLS

A strong system of internal controls can reduce the opportunity for theft significantly. Internal controls are especially critical for a contractor whose employees are scattered at various jobsites. In this case, systemic controls are necessary because centralized oversight of employees physically located in more than one place is not possible. To protect the bottom line, it is imperative that a contractor implement the following internal controls:

- Make sure there are clear lines of authority and responsibility between employees and departments. Accounting and operating functions should be separated as much as possible.
- Set up a division of duties so that no one person handles financial transactions from beginning to end.
- Select personnel carefully by utilizing background checks.
- Supervise and enforce internal controls. Management must always be alert to signs of changing employee behavior and potential breakdowns in the internal control system.

FIDELITY INSURANCE

Of course, no internal control system is 100-percent foolproof. The criminal mind can be creative and, if focused, can find ways to overcome internal controls. If the internal controls are overcome and a significant loss occurs, a contractor needs fidelity insurance as a second line of defense. Fidelity insurance, sometimes called a fidelity bond, protects the contractor against loss incurred due to the dishonest acts of the employee.

Most insurance companies provide employee dishonesty coverage under a policy that provides multiple coverages, including employee dishonesty and theft of money and securities by persons other than an employee. Although there may be some differences among the policies available in the market, they are basically similar in terms of the structure and coverages offered. For the sake of simplicity, this article will discuss the Crime Protection Policy that was published by The Surety & Fidelity Association of America.

The Crime Protection Policy provides the following six different coverages:

- **Employee dishonesty.** This pays for loss of money, securities, and other property resulting directly from the dishonest acts of an employee with manifest intent to cause the insured a loss and obtain financial benefit. This is the cornerstone of the policy and the main reason why businesses purchase the Crime Protection Policy.
- **Forgery or alteration.** This pays for losses resulting directly

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from forgery or alteration of checks and other instruments that are made or drawn upon the insured. On a weekly basis, a contractor issues hundreds of checks to vendors, suppliers, and subcontractors. This coverage protects the contractor against the risk of the checks getting into the wrong hands.

- **Inside the premises.** This pays for loss of money and securities inside the premises or banking premises resulting from theft, disappearance, or destruction. Many property coverages do not cover money and securities. This coverage fills that gap.
- **Outside the premises.** This pays for loss of money and securities outside the premises while in the care and custody of a messenger or armored motor vehicle company resulting from theft, disappearance, or destruction.
- **Computer fraud.** This pays for loss of money, securities, and other property resulting from the use of any computer to fraudulently cause a transfer of the property to a person or place outside the premises. In today's electronic age in which transactions are computer driven, a contractor has exposures that were not even contemplated 5 or 10 years ago.
- **Money orders and counterfeit paper currency.** This pays for losses resulting directly from having accepted in good faith, in exchange for merchandise, money, or services, counterfeit United States or Canadian currency or money orders that are not paid upon presentation.

The following other coverages are available by rider:

- **Client's property.** This pays for loss of a client's property resulting from the dishonest acts of an employee with manifest intent to cause the insured a loss and obtain financial benefit.
- **Funds transfer fraud.** This pays for loss of funds resulting directly from a fraudulent instruction directing a financial institution to transfer funds from the insured's account.

The insured may select only those coverages that he or she wants. Each coverage may have a separate limit of insurance and a separate deductible. The Crime Protection Policy is on a "discovery" basis. That is, the policy pays for losses sustained by the insured at any time and discovered during the policy period.

PROTECTING BUSINESS ASSETS BETTER

To protect its bottom line, a contractor must address the very real risk of employee theft by implementing a robust internal control system and obtaining fidelity insurance. A multiple-line policy, such as the Crime Protection Policy, will afford protection against employee theft in addition to other operational exposures, such as theft of money and securities, and forgery.

All employers think they know their employees. But the statistics show that theft by employees can happen and does happen on a regular basis. For more information regarding protecting the bottom line with fidelity insurance policies, contractors should consult with their insurance agent. ◆

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[1] See, e.g., *Employment References—Speak No Evil, Hear No Evil: A Proposal for Meaningful Reform*, 39 AM. BUS. L.J. 445, 449 (2002).

[2] Association of Certified Fraud Examiners, "Report to the Nation on Occupational Fraud & Abuse at 11" (2008).