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The First Line of Defense to Preventing Employee Embezzlement

By Brett D. Watson

Multi-billion dollar Ponzi schemes like the one orchestrated by Bernard Madoff receive widespread, international attention. However, in times of economic crisis such as the present, the more "garden variety" types of financial fraud, including employee embezzlement, fall below the headlines even as their numerosity increases. In one study, 80 percent of the participating certified fraud examiners found that fraud activity spikes during times of economic distress. See *"Occupational Fraud: A Study of the Impact of an Economic Recession by the Association of Certified Fraud Examiners,"* (http://www.acfe.com/documents/occupational-fraud.pdf).

Although employee embezzlement schemes take many different forms, the most common fact pattern involves a bookkeeper or other trusted employee who gains access to their employer's blank checks. That employee will forge his employer's signature on the checks, making payments either directly to himself or to fictitious payees. The employee then deposits the funds into his own account.

In a recent, highly publicized case, the half-brother and former business manager of stand-up comedian Dane Cook was arrested for allegedly embezzling millions of dollars from the comedian. The brother was Cook's business manager since the early 1990s. Allegedly, beginning in 2004, the brother began siphoning money from Cook's accounts. In one instance, he allegedly stole $3 million by forging Cook's signature on a single check. In October 2010, he pleaded guilty and was ultimately ordered to pay $12 million in restitution to Cook.

In Cook's case, the wrongdoer was ordered to pay restitution. However, in many cases, when the employer discovers the embezzlement, there is little economic utility in pursuing the employee because he or she has either spent the money and is judgment-proof, or has been incarcerated. Employers, unwilling to admit their own failure to properly supervise their employees, look to the only deep pocket they can find — their bank.

A common misconception is that the bank owes its customers a duty to monitor their accounts. However, the relationship between a bank and its depositors is that of debtor and creditor, and banks owe no fiduciary duty to their depositors. *Copesky v. Superior Court*, 229 Cal.App.3d 678 (1991). A bank also is not required to monitor account activity or make inquiries as to how customer funds are spent. *Software Design and Application Limited v. Hoefer & Arnett*, 49 Cal.App.4th 472 (1996). Due to this misconception, and to desperation, employers often file what, in many instances, are meritless and costly claims against their banks.

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Fortunately for banks, both statutory and case law defenses make it increasingly difficult for an employer to recover against a bank for the acts of the employer's dishonest employees. When dealing with a forged check claim, banks typically have two defenses: the customer's delay in notifying the bank and filing a lawsuit, or contributory negligence.

In enacting Code of Civil Procedure Section 340, the Legislature sought to bring uniformity to claims involving forged or unauthorized endorsements. This section provides a one-year statute of limitations period, triggered from the date that a routine monthly account statement reporting the unauthorized check is provided to the customer, and acts to bar stale claims regardless of whether or not the bank was negligent in paying the check. *Chatsky and Associates v. Superior Court*, 117 Cal.App.4th 873 (2004).

This time bar is premised upon the public policy consideration that the employer is always in a better position than its bank to discover bookkeeper fraud, simply by properly supervising its employees and exercising its duty to review monthly account statements. *Roy Supply Inc. v. Wells Fargo Bank*, 39 Cal.App.4th 1051, 1065 (1995). Notably, the courts have routinely held that a bookkeeper who intercepts the monthly statements and "prevents" the employer from reviewing them does not excuse the employer of this duty. *Kiernan v. Union Bank*, 55 Cal.App.3d 111 (1976).

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Darryl McCauley, the half brother of comedian Dane Cook, appears at his arraignment, Dec. 31, 2008, at Woburn District Court in Woburn, Mass.

Further, Commercial Code Section 4406 provides for claims preclusion. Upon receipt of its monthly account statement, Section 4406 requires the customer to report unauthorized checks within a period "not exceeding 30 days." If the account agreement between the bank and its customer provides for a shorter reporting period (often referred to as a contractual "cut down" provision), such reduced periods will typically be upheld, and courts have routinely upheld cut down provisions limiting the reporting period to as little as 14 days. Commercial Code Section 4103.

The effect of Section 4406's claim preclusion ties together the issues of timeliness of reporting the loss and contributory negligence. If the bank is able to demonstrate that the customer failed to timely report the unauthorized checks and is further able to demonstrate that such failure contributed to the loss, the customer will be unable to assert a claim against the bank. However, if the customer is able to demonstrate that the bank did not exercise ordinary care in paying the item, the loss is allocated based upon the respective fault of the customer and the bank.

Taking the contributory negligence concept further, in employee embezzlement situations there typically is a single wrongdoer — a bookkeeper or other trusted employee. That person, perhaps emboldened by their employer's failure to catch the first forgery, will orchestrate a scheme in which the employee will forge a series of checks over an extended period of time.

In 2002, the landscape of such claims was drastically changed by the Court of Appeal's decision in *Espresso Roma Corp. v. Bank of America*, 100 Cal.App.4th 525 (2002). The facts typify the routine, long-term embezzlement scheme. Espresso Roma employed a bookkeeper who, starting in late 1997, stole blank checks, learned how to generate company checks on his home computer, forged his employer's signature, and used those checks to pay his personal bills. The bookkeeper acted to conceal his embezzlement by intercepting the mail and removing the forged checks from the envelopes before delivering the monthly account statements to his employer. Espresso Roma did not discover this scheme until mid-1999 — nearly two years after the embezzlement began, and after the bookkeeper had embezzled more than $330,000.

The court applied the so-called "repeater rule," codified in Commercial Code Section 4406(d), which provides that if a customer fails to timely report the *first* unauthorized check forged by a single wrongdoer (within the same 30 or fewer day time period), the customer is precluded from recovering for any subsequent checks forged by the same wrongdoer.

The customer can attempt to overcome this preclusion by demonstrating that the bank failed to exercise ordinary care in paying the items. To establish ordinary care, banks typically rely on expert testimony. In *Espresso Roma*, Bank of America's expert testified that it, along with similarly sized banks in the San Francisco Bay area, are "bulk filers" — meaning that it processes millions of checks and does not visually examine every check or verify signatures. Although the bank uses fraud filters, these filters cannot "catch a crooked employee who forges his employer's checks, which only the employer would know are forged."

The court held that Bank of America acted with ordinary care, and, therefore, the customer's failure to timely report the first of its bookkeeper's forgeries barred the customer's recovery. This was a landmark decision for the banks, because the "repeater rule," coupled with the bulk-filing standards, provides even greater protections to banks than the one-year statute of limitations.

Despite a noticeable spike in the filing of lawsuits against banks in such situations, they are largely insulated from liability for such actions because of the employer's superior position to prevent such losses. Employers must properly supervise their employees, carefully review their monthly account statements, and timely report any suspected unauthorized transactions. Although it is often difficult to admit that one's own actions (or inactions) contributed to financial loss, employers must realize that they, not their banks, are the first line of defense in preventing and detecting employee embezzlement. Indeed, common sense dictates that prevention, or even early detection, provides greater protections than searching for a scapegoat.

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