# STEALING – BACK TO THE BASICS

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# STEALING – BACK TO THE BASICS

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## *I. Introduction*

Since time began, people have stolen monies and items that belong to others. Through the years, various words and slang terms have been used by the media and others to describe what was stolen and how it was stolen, some being more accurate than others. This paper will try to expunge the "media myth" and "popular vernacular" to delve into what people steal and how the stealing is concealed, in a format designed to expedite claim handling, ameliorate reserve accuracy, enhance underwriting, and clarify legal misunderstandings. The paper will address the various legal issues and precedents generated from the misunderstandings and impinging issues brought forth by the use and misuse of media myth and popular vernacular in describing people stealing.

## *II. Fraud*

### A. MEDIA AND POPULAR PERSPECTIVES

In an article written in 1906[1] detailing Massachusetts Banking Commissioner Pierre Jay's speech on bank embezzlement, the following words were used to describe stealing and fraud: *irregularities*, *embezzlement*, *excessive loans*, *unsound loans*. Nothing much had changed by the time the 2006 Report to the Nation[2] was issued, the front page of which referenced words like *inventory theft*, *skimming*, *check tampering* and *payroll fraud*. While the words certainly add spice to any article, they are neither accurate nor practical in the context of underwriting or fidelity claims handling.

### B. WHAT IS FRAUD

From a general point of view, fraud is a broad concept. Auditors' interest in fraud, however, relates to the material misstatement of financial statements. While it is possible that a fraud situation may fit into more than one category of description, an auditor is concerned about the material effect of inaccuracies in financial statements. Thus an auditor's objective is not to detect fraud but to ascertain the reasonable accuracy of financial statements.

The critical difference between fraud and error in such situations is whether the misstatement is intentional or unintentional. Auditors consider two types of misstatement relevant:

- Misstatements arising from fraudulent financial reporting; and
- Misstatements arising from misappropriation of assets.[3]

For forensic accountants and CFE examiners, there are three major types of fraud:

Asset Misappropriation;
Fraudulent Statements; and
Corruption.[4]

"Asset Misappropriation is any scheme that involves the theft or misuse of an organization's assets."

"Fraudulent Statements is the falsification of an organization's financial statements to make the organization appear more or less profitable."

"Corruption is any scheme in which a person uses his or her influence in a business transaction to obtain an unauthorized benefit contrary to that person's duty."[5]

Out of 1,507 frauds studied, 68.87% of the fraud consists of asset misappropriation.[6] Other studies indicate:

- Approximately 13% of employees are fundamentally dishonest.
- Employees out-steal shoplifters.
- Approximately 21% of employees are honest.
- Approximately 66% of employees are encouraged to steal if they see others benefitting without repercussions.[7]

While fraudulent financial statements and corruption occur less frequently, when they do, they involve asset misappropriation 75.4% and corruption 28.3% of the time.[8]

So when it comes to asset misappropriation, what do individuals steal? A more fundamental question is: what is an asset? "Asset" has been defined as:

A resource:

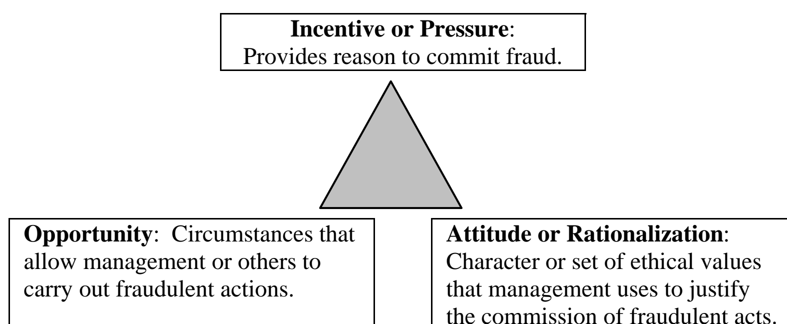
(a) controlled by an entity as a result of past events; and
(b) from which future economic benefits are expected to flow to the entity.[9]

The results of a recent study indicate that 87.7% of misappropriated assets consist of cash, including checks and money orders.[10]

Not surprisingly, various reports indicate that employee fraud is increasing. From 1998 to 2003, KPMG's Fraud Survey found that the percentage of companies polled that experienced employee fraud increased from 62% to 75%.

## *III. Why People Steal*

The AICPA Accounting Standard Board recognizes a commonly known concept of the *Fraud Triangle*, depicted as follows:[11]




The *Fraud Triangle* has aspects:

i. Pressures to commit fraud;
ii. Opportunity; and,
iii. Rationalization.

### A. PRESSURES TO COMMIT FRAUD

Pressures to commit fraud include financial, vices (addictions), work-related and miscellaneous. Financial pressures consist of greed, living beyond one's means, high personal debt, medical bills, and unexpected financial needs.[12] As an aside, medical debt prompts the filing of more than 50% of personal bankruptcies.[13] Pressures brought out by addiction have changed over time; whereas, in the past, the majority of cases were drug-related, in recent years, due to the burgeoning number of lotteries and gambling venues, the majority are now gambling-related. A recent study by the State of Maryland illustrates the severity of losses and debt among those addicted to gambling:

| % of Gambling Addicts | Amount of Debt |
|---|---|
| 47.8% | < $10,000 |
| 25.0% | between $10,000 and $50,000 |
| 12.8% | between $50,000 and $100,000 |
| 12.2% | > $100,000[14] |

Work-related pressures are well-documented in cases such as Enron among Andrew Fastow and other Enron employees.[15] Other pressures, while less common, include boredom, daring (trying to see if one can get away with the "perfect crime"), and demands by others (for example, one's spouse) for a better lifestyle.

## B. OPPORTUNITIES TO COMMIT FRAUD

The second element of the *Fraud Triangle* is the opportunity to commit fraud. The three components of opportunity to commit fraud are the perceived: (1) ability to commit; (2) ability to conceal; and (3) ability to avoid punishment.

The factors that increase opportunities to commit fraud include:

a. Inability to judge quality of work;
b. Lack of disciplinary action;
c. Asymmetrical information;
d. No audit trail; and
e. Lack of controls or circumvention of controls that prevent and/or detect fraudulent behavior.[16]

When it is difficult to measure their knowledge or quality of work, it is tempting for individuals to take advantage of the situation. Conversely, testing has parameters and standards that allow for comparison. For example, after 200 police lieutenants achieved abnormally high scores on an exam for a captain position, a closer look at the examinations was taken. It was discovered that an examiner had substituted correct answers for wrong ones marked by the candidates.[17] The examiner's greed skewed the overall results. This is an example of results and work that can be measured. When results, performance, or quality cannot be measured or controlled, however, fraud becomes a crime of opportunity.

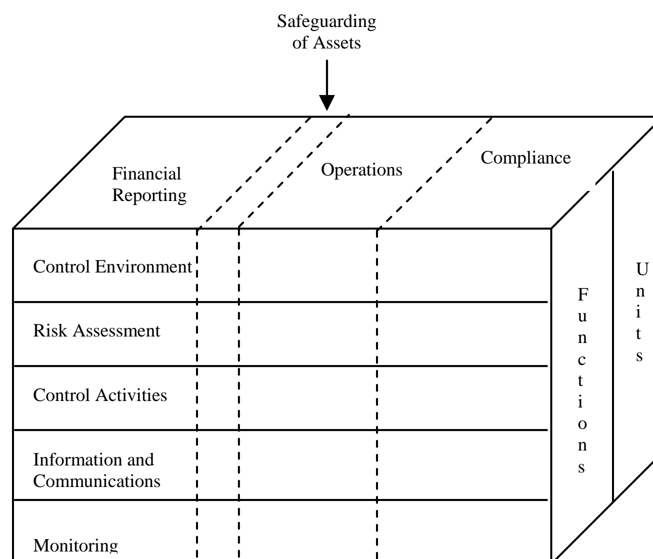
The lack of criminal consequences is the yin and yang of the crime policy claims versus those made under property policies. While property policies generally require an insured to file a police report when the law is broken, most crime policies lack a similar requirement. The reasons generally given by insureds for their decisions not to pursue criminal prosecution of a wrongdoer typically include avoidance of defamation exposure, an insured not wishing for its reputation to be damaged in a public forum, and the desire to avoid the hassle entailed by such investigations and proceedings. A couple of studies suggest that the pre-sentencing reports of more than 40% of white-collar offenders reflected prior arrests.[18] [19] Even in situations where an insured fervently wishes for the thief to be criminally prosecuted, the overworked state of the public agencies charged in pursuing adjudication of such charges and the likelihood, given the non-violent nature of white-collar crimes, that a conviction will not result in imprisonment, further dim the prospects that most thieves will be punished for their crimes.

When one party has more or better information regarding a transaction than the other party to that transaction, asymmetrical information results. Such causes an imbalance of power that often is used to take advantage of elderly or non-English speaking individuals. Some examples of these situations are used-car salespersons, mortgage brokers, loan originators, stockbrokers, real estate agents, payday lenders, and life insurance variable

annuity agents.[20] Ignorance and apathy of consumers also exacerbate the asymmetrical information.

Lack of controls and audit trails, as well as the existence of inadequate controls, is a situation of which a smart thief often takes advantage. More likely than not, that thief will use an income statement transaction, because it is easier to conceal his theft, rather than a balance sheet transaction because of the monthly, quarterly and annual turnover of income statement results. The destruction of or failure to retain certain types of documentation, such as cash receipts, register tapes, or even videotapes, also allows thieves to conceal their activities.

The following are controls that prevent or mitigate dishonesty and losses and seek to safeguard assets.[21] The safeguarding of assets involves the reporting of the assets and the use of the assets in operations to generate more assets. To ensure the accuracy of assets, the use of assets and the generation of assets, the controls, communication and monitoring technique are employed:




To prevent the lack of controls and audit trail, there are three major components that can have a direct effect on preventing the misappropriation of assets: *Control Environment*, *Accounting Operations* (processes) and *Control Activities* (procedures).

*Control Environment* is the personality of the entity and of its management, as well as that of the individuals. The AICPA Standards of Field Work indicate the *Control Environment* includes:[22]

a. Integrity and ethical values that are limited and cannot rise above those who create, enforce and administer those values. As a proverb notes: "A fish rots from the head;"

b. Commitment to competence, i.e., placing competent employees in the appropriate positions is an essential function of a safe and healthy organization, which requires continued encouragement and revisions in training;

c. The importance placed by an entity's Board of Directors or Audit Committee in the entity's financial reporting, as well as the oversight and monitoring of management, internal auditing, and external accountants;

d. Management philosophy and operating style, as such relate to, among other things, reserving style, the transparency of financials, and manner in which financial results are reported;

e. An organization's structure which, if sound, will have in place policies and procedures for asset custody and transaction approval and reconciliation;

f. Assignment of authority utilizing concepts of objectives, missions, limitations and accountability; and,

g. Human resources policies and practices emphasizing hiring, orientation, evaluation, training, disciplining, promotions and incentives designed to obtain and retain the best and most desired employees.

The second major component for reducing fraud is the *Accounting Operations*, which records and processes accounting transactions within functional cycles of accounts payable, inventory purchasing, and the like. Without an organized, methodical and accurate accounting system, it is difficult to differentiate between unintentional errors and actual fraud.

The third essential component of the control structure is the Control Activities. *Control Activities* [23] include:

- Performance reviews encompassing budgets, performance analyses, forecasts, common size analyses, and year-to-year comparisons;

- Information processing designed with sufficient controls to ensure accuracy, completeness, and transactional authorization. Application controls apply to individual transactions to ensure the processes that occurred were authorized and recorded completely and accurately, while general controls encompass password requirements, encryption and firewall controls to prevent financial changes from occurring without a record or audit trail;

- Physical controls, like vaults, locks, safes, registers, fences, and the use of armored car services, to safeguard assets from fraud; and,

- Segregation of duties aimed at preventing errors or intentional irregularities. The ideal segregation of duties seeks to separate custody, authorization, recording, and reconciliation. For example, the individual with custody of the blank checks should not also have signature authority, recording or reconciliation duties, just as the person who reconciles accounts should not have custody of checks, check signature authority or recording responsibilities.

### C. RATIONALIZATION TO COMMIT FRAUD

The third element of the F*raud Triangle* is how the principal(s) explain their actions[24], otherwise known as "rationalization." What did Jeff Goldblum's character in *The Big Chill* say about the necessity of rationalization in all of us? It is even more true when it comes to a thief. The process of logical or illogical justification for a belief, decision, action or lack of action, rationalization is a defense mechanism in which unacceptable behaviors are explained to avoid the true reasons for one's actions.[25]

Simply put, the *Fraud Triangle* provides a conceptual framework of the ingredients needed to motivate, allow and justify (in their own minds) misappropriation of assets by employees.[26] The reasons to steal have been discussed. The next step is to determine what is stolen. The theft of liabilities is a fraud commonly characterized as fraudulent financial statements. In jest, the authors do not believe management would take too much exception to disappearing liabilities. In fact, only assets can be stolen.

## *IV. What is Stolen*

Most of us understand the financial elements of a company or entity consist of:

Assets,
Liabilities,
Equity,
Investment by owner,
Distribution by owner,
Revenue,
Expenses,
Gains,
Losses, and
Comprehensive income.[27]

The only thing employees steal is assets.

Experts and professionals routinely confuse and interchange terms identifying what people steal and how people steal.

As for what people steal, when it comes to misappropriation, people steal only one thing – assets. Assets can be cash or noncash assets, including raw materials, finished products, client lists, databases, and purchased products. Cash, however, is stolen by thieves 87% of the time.[28] As any beginning accountant knows, cash is simply a subset of assets, of which there are three basic categories:

Assets;

Liabilities; and

Equity.[29]

It goes without saying that employees take assets; they don't steal liabilities.

## *V. How People Conceal*

Many authors, experts, and professionals outside the insurance industry have debated and written at length about how people steal. Like the courts cited above, they expound on such methods, using words such as *kiting*, *lapping*, *pyramiding*, *altering*, *voiding*, and many more. Such descriptions are, however, arguably specious.

> Misappropriate – to appropriate to a bad, incorrect or dishonest use.[30]
>
> Steal – 1 To take or appropriate (another's property, ideas, etc.) without permission, dishonestly or unlawfully, esp. in a secret or surreptitious manner 2 to get, take or give slyly, surreptitiously, or without permission [to *steal* a look, to *steal* a kiss] 3 to take or gain insidiously or artfully [to *steal* someone's heart, to *steal* the puck in hockey] 4 to be the outstanding performer in (a scene, act, etc.), esp. in a subordinate role 5 to move, put, carry, or convey surreptitiously or stealthily (*in*, *into*, *from*, *away*, etc.) 6 *Baseball* to gain (a base) safely without the help of a hit, walk, or error, usually by running to it from another base while the pitch is being delivered – *vl*. 1 to be a thief; practice theft 2 to move, pass, etc. stealthily, quietly, gradually, or without being noticed 3 *Baseball* to steal or attempt to steal a base – n. [Informal] 1 an act of stealing 2 something stolen 3 something obtained at a ludicrous cost.[31]

People steal or misappropriate by a single method of taking what does not belong to them. The complexity and challenges attendant such thefts arise in the concealment. To lie is easy, but the remembering what was a lie becomes the challenge.

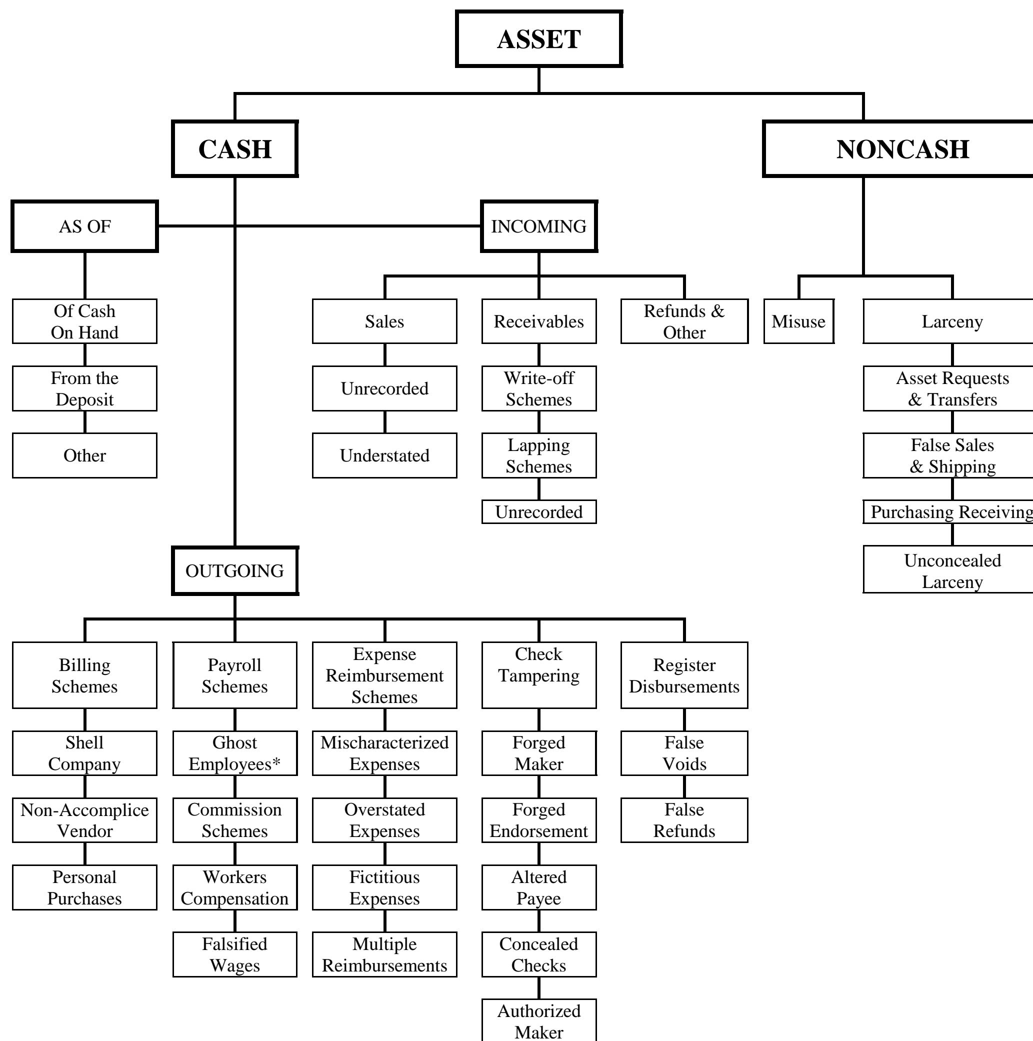
> Conceal – 1 To put out of sight; hide 2 to keep from another's knowledge; keep secret.[32]

Stealing is easy; keeping it concealed is more difficult and can involve a multitude of methodologies and schemes. The next step in the paper is to address how individuals conceal stealing and how best to conceptualize such concealment.

To understand how people conceal requires one to focus upon what type of assets are stolen: cash and noncash and whether such assets are incoming to the entity, outgoing from the entity, or an element of the entity.

The Association of Certified Fraud Examiners and other authors use a *Uniform Occupational Fraud Classification System* detailing fraud by categories.[33]

Using the categories of fraud, we detail the categories as methods of concealment:



To understand the concealment is to understand where in the process the asset is stolen and what accounting process is used to conceal the asset that is missing or misused:

- Theft of cash
  Stealing checks
  Diverting cash receipts
  Voiding cash registers
  Altering bank deposits
  Forgery
  Misusing pension fund assets
  Stealing petty cash
  Using company checks to pay personal bills

- Presenting fraudulent invoices
  Fictitious billings
  Overstated billings

- Theft of inventory

- Collusion with customers or suppliers
  Kickbacks*
  Bid rigging*
  Dummy suppliers*
  Overstated prices*

- Lapping*

- Kiting*

- Using of company resources
  Personnel equipment or materials
  Purchase orders

- Credit card

- Insurance fraud
  Misstating benefits
  False claims

- Medical claim fraud

- False entries in accounts
  To increase performance reports
  To cover missing assets

- Travel reimbursement abuse
  False expenditures
  Including personal expenditures
  Advances not repaid

- Unauthorized sale of assets
  Inventory
  Equipment
  Scrap

- Computer crimes
  Changing records
  Diverting cash

- Payroll crimes
  Cashing unused paychecks
  Overstating hours
  Ghost employees

## *VI. How People Steal*

Knowing employees steal assets, they need a perceived opportunity to steal. They believe they have superior (asymmetrical) information, no audit trail, a perceived lack of controls, or circumstances whereby controls can be circumvented. The concepts and description of how people steal is really the method of how employees conceal, circumvent, or create opportunities to misappropriate assets. Some common methods are described below.

Innumerable methods have been devised by thieves, most having an infinite number of variations reflecting their individual circumstances, despite which many of those methods can be placed into several categories. Those categories include:

## A. LAPPING

"Lapping" typically involves the theft of cash, which is concealed by way of using others' checks to replace the stolen cash. Lapping can be used with deposits, checks, accounts, receivables, just about any asset. The concept is to use future incoming assets to conceal the asset (cash) that was stolen today. This type of scheme, along with some of the problems attendant thereto, was described by the Missouri Court of Appeals thusly in the case of *State v. Brown*, 689 S.W.2d 63, 65 (Mo.App., 1985):

> In a lapping fraud, a cashier pilfers currency from payment receipts and covers the shortage by showing later payments made by other customers as credits to the pilfered accounts. This, in turn, creates a need to cover the misapplied credits and further pilferage accumulates. As more and more credits to accounts must be manipulated, the delay between the date a customer's payment is received and the date on which that account is satisfied lengthens. The use of this scheme was confirmed by the audit of the daily bank deposits during the test period. On each day, although the total deposit agreed with the record of total receipts for the day, the deposit was composed of a larger amount of checks and a smaller amount of cash than the validating tapes showed had cleared through the cashiers' windows.
>
> In implementing a lapping scheme, it is necessary that the thief have access to substantial amounts of cash and also be able to arrange the credit of payments made by checks to cover the misappropriated cash.

Another court described "lapping" as:

> . . . an operation recognized in accounting circles as a sophisticated type of embezzlement.
>
> 'Lapping' consists of accepting checks and failing to account for the receipt thereof in the books (i.e., in the court's registry and transcript or in any other records that would indicate an intake of funds by check). To make [t]he books balance, it is necessary for one to remove cash in an amount equal to the face value of the checks received. Thereafter the perpetrator of the scheme records the checks on the listing tapes and deposits them in the bank to replace the money taken. Since no record has been made of the checks having been received, there is no apparent loss when the checks are used to replace the same amount of cash in the bank deposit.
>
> One of the essential elements of a successful 'lapping' system is the destruction, secreting or failure to prepare records to account for the intake of funds by check.
> *State v. Randecker*, 487 P.2d 1295, 1299-1300 (Wash., 1971).

The opinion rendered in *State v. Froning*, 328 N.W.2d 333 (Iowa, 1982), illustrates the occasional misunderstanding by courts and others of exactly what constitutes a "lapping scheme". In that case, the defendant had deposited corporate checks into his personal account and issued checks from his account back to corporation, which, an accounting expert had testified, constituted a "lapping scheme". Similarly, in the unpublished case of *Blackstock v. The State of Texas*, 2007 WL 43879 (Tex.App., 2007), the court references the prosecution's mistaken characterization of such scheme as "fake deposits", when, instead, the preparation of inaccurate deposit records by the thief was the manner in which she covered up her thefts of cash.

## B. PONZI SCHEMES

"Ponzi scheme" is the moniker owing to the fraudulent investment scheme perpetrated in the 1920s by Charles Ponzi, usually involving high-blown investment plans guaranteed to produce exceedingly high returns, which promises can only be kept by later investors' money being paid to earlier investors to meet the promised projections.

> A 'Ponzi' scheme is a term generally used to describe an investment scheme which is not really supported by any underlying business venture. The investors are paid profits from the principal sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid. The person who runs this scheme typically uses some of the money invested for personal use. Usually this pyramid collapses and most investors not only do not get paid their profits, but also lose their principal investments. Citations omitted.
> *In re Randy*, 189 BR 425, 437 [FN17] (Bkrtcy, N.D.Ill., 1995).

## C. FICTITIOUS EMPLOYEE OR PADDED PAYROLL

Fictitious Employees or Padded Payroll – In these schemes, typically, an employee "pads" the employer's payroll by adding fictitious or former workers thereto and then diverts the paychecks issued to those so-called employees. In another of the myriad versions of this scheme, an employee generates bogus invoices or reprocesses already-paid invoices, thereby obtaining payment for services and goods never provided.

## D. CHECK KITING

Check Kiting – A scheme best described by the United States Supreme Court, in the case of *Williams v. United States,* 458 U.S. 279, 281 n.1, 102 S.Ct. 3088, 72 L.Ed.2d 767 (1982):

> [A] **check-kiting** scheme typically works as follows: 'The check kiter opens an account at Bank A with a nominal deposit. He then writes a check on that account for a large sum, such as $50,000. The check kiter then opens an account at Bank B and deposits the $50,000 check from Bank A in that account. At the time of deposit, the check is not supported by sufficient funds in the account at Bank A. However, Bank B, unaware of this fact, gives the check kiter immediate credit on his account at Bank B. During the several-day period that the check on Bank A is being processed for collection from that bank, the check kiter writes a $50,000 check on his account at Bank B and deposits it into his account at Bank A. At the time of the deposit of that check, Bank A gives the check kiter immediate credit on his account there, and on the basis of that grant of credit pays the original $50,000 check when it is presented for collection. By repeating this scheme, or some variation of it, the check kiter can use the $50,000 credit originally given by Bank B as an interest-free loan for an extended period of time.'

As described recently by the Kansas Court of Appeals in *Exchange State Bank v. The Kansas Bankers Surety Company*, 177 P.3d 1284, 1285 (Kan.App.2008), noting that the common understanding of "check kiting" and that contained in the bond in issue tracked fairly closely, kiting consists of the "constant systematic back and forth deposit of funds between ... two or more accounts utilizing checks of approximately the same amount to create the appearance of valid funds in the account" involving "deposits with the Insured drawn against uncollected funds deposited in another institution to create the appearance of valid funds in the account at the other institution . . ."

## E. FICTITIOUS LOANS

Fictitious Loans -- The processing of fake loans used to facilitate and conceal the theft of monies usually involves the thief initiating loans in the names of real or imagined people, then diverting the checks issued or monies deposited to fund such loans. In the case of *St. Paul Fire and Marine Insurance Company v. Branch Banking and Trust Company*, 643 F.Supp. 648, 649, the presiding court described a typical fictitious loan scheme:

> Generally, Riley's scheme worked as follows: He would prepare fictitious loan documentation, and obtain the loan proceeds either by cashier's checks payable to the ostensible borrowers or by direct deposits to checking accounts in the names of ostensible borrowers but controlled by Riley. When one of these loans matured, Riley would either cause that loan to be renewed or he would generate another fictitious loan, in the same or in a different name, and apply part of the proceeds to pay principal and interest on the mature loan. Riley had control over the signature authority of the checking accounts used and over the addresses for the checking and loan accounts used in the scheme. Some of the accounts were for fictitious entries, and others were in the names of actual persons whose signatures Riley forged.

Similarly, the court in *ITT Consumer Financial Corporation dba ITT Financial Services v. Tovar*, 932 S.W.2d 147, 150-151, (Tex.App.-El Paso, 1996), after noting that it was undisputed that the appellant's audit program was not designed to detect fraud, went on to describe how one of its employees was able to exploit such laxities by stealing money through the creation of fictitious loans.

> It was eventually revealed that Chavira, between May 1987 and January 1990, embezzled $59,178 from Appellant by creating twenty-nine fictitious loans. Chavira created files to make the fictitious loans appear legitimate, then later destroyed the files for twenty-seven of the twenty-nine accounts. Chavira would prepare a loan application and then instruct other branch employees to do the required pre-loan verifications, explaining that the customer would come to the office after hours to close the loans with him. Chavira also made entries into the computer system indicating that a check was received. Thus, employees, believing that a post-dated check had been received, would not follow up with the customer. Beginning in October 1989, Chavira kept control of all post-dated checks received by the Branch, making it more difficult for employees to know what checks had been received. Eventually, he used one month deferments to make the delinquent accounts appear current. Although Appellant allowed customers two deferments a year, some accounts had as many as nineteen deferments.

### F. KICKBACKS

Kickbacks -- The diversion of asset through kickbacks, defined by *Merriam-Webster*, as the "return of a part of a sum received often because of confidential agreement or coercion", usually arises through the collusion between an inside party, one able to facilitate or approve the payment of invoices, and someone working on the outside, who can submit such invoices, and thereafter "kick back" a portion of the monies received in payment thereof to the party providing the approval necessary to obtain payment. Kickbacks is a subset under briberies, as is bid rigging.

### G. FALSIFICATION OF EXPENSE REPORTS

Falsifying Expense Reports -- The inflation of one's expense reports is a well-worn method of stealing from one's employer, one encompassing several methods of padding such reports. In deciding whether a defendant's compulsive shopping and depression constituted diminished mental capacity entitling her to a lesser sentence for wire fraud, the Seventh Circuit Court of Appeals in *United States v. Roach,* 296 F.3d 565, 567 (C.A.7 (Ill.) 2002, related numerous ways in which that defendant had padded her expense reports, thereby providing a good overview of this topic:

> The falsifications took several different forms. She padded her expenses in approximately 160 instances, obtaining just over $19,000 to which she was not entitled. On 102 occasions, she submitted expense reports for

> reimbursement of air fares that had actually been billed directly to Andersen, and in this way she obtained around $89,000. On twenty-five occasions, Ms. Roach requested reimbursement for conferences that she had registered for but had not attended, for a total of over $115,000. On thirteen occasions, she submitted expense reports for expenses that Andersen had already reimbursed, for a total just short of $16,000. And on three occasions, Ms. Roach sought and obtained reimbursement for personal expenses which she falsely labeled as business expenses, totaling just over $1,200. It does not appear to the Court that each of these 323 incidents of false reporting represents a separate expense report; though it is not entirely clear, it appears that they represent false line items on a somewhat smaller number of reports, though the exact amount is not clear to the Court. The total amount that she obtained from Andersen by fraud over the three years from April 1996 through April 1999 is $241,061.

## H. BID RIGGING

Bid Rigging -- The term "bid rigging" alludes to the manipulation or "fixing" of bids generally designed to ensure inflated payments for the work being bid upon; in essence, the term is self-descriptive. Said means of theft can present in a myriad of forms depending upon the type of bidding being performed. Bid rigging is a subset under briberies, as is kickbacks.

The authors could not pass up the chance to cite the following holding of the District of Columbia Circuit Court. In a memorandum opinion disposing of a slew of motions filed on behalf of defendants charged with rigging bids, the court classically stated:

> Also DENIED is the joint HII-HC Motion [575] to exclude use of the term 'bid rigger' as somehow constituting a pejorative, 'erroneous and inflammatory label.' This is a case about bid rigging. In a case of theft, the Court would not ban the word 'thief,' a title generally not held in high regard. These defendants do not identify any real way in which 'bid rigger' or 'bid rigging' are unduly prejudicial phrases. They assert that '"Bid-rigging" is the common term used for certain violations of Section 1 of the Sherman Act.' The Court would be astounded if any juror in this trial were to hear the phrase 'bid rigger,' emit a shudder of horror, and whisper to her neighbor 'they're talking about *the* Sherman Act.' 'Bid rigging' is simply a common term used to describe the exact kind of conduct described in this case. This is not an instance where one party seeks to incite by replacing a term necessary to the case-such as 'thief' in a theft case or 'drug dealer' in a narcotics trafficking case-with a word that goes beyond the descriptive into the purely pejorative and insulting-such as 'hoodlum' or 'thug.'
>
> Moreover, the plaintiffs have to call the conduct at issue *something*. Defendants do not identify what the parties and the Court are supposed to call the kind of scheme alleged other than what it is: bid rigging. Webster's

> defines 'rig,' in the verb form used here, as meaning 'swindle,' 'to manipulate or control usually by deceptive or dishonest means,' or 'to fix in advance for a desired result.' Webster's Ninth New Collegiate Dictionary (1990). Roget's lists its synonyms as 'arrange outcome,' 'doctor,' 'engineer,' 'fake,' 'falsify,' 'fiddle with,' 'fix,' 'manipulate,' 'tamper with,' and 'trump up.' Roget's New Millenium Thesaurus (2006). 'Rig' seems much more innocuous than any of those alternatives. If the parties cannot use plain terms to describe what is at issue here, it will add considerable confusion and delay to the course of the trial. Emphasis original.
> *United States v. Bill Harbert International Construction*, 2007 WL 842077 (D.D.C.).

The foregoing categories constitute a small fraction of the ways in which thieves conceal their schemes. Nevertheless it is important to keep in mind that such schemes are reflective not only of the fact that money has been stolen but how such thefts are concealed.

## VII. *Legal Cases Spurred by Misunderstanding of What is Stolen and the Process Compromised*

One of the best forms of learning is from history. The following are cases wherein the courts did not understand the basics of what was stolen.

### A. BANK OF HUNTINGDON v. TROY SMOTHERS AND UNITED STATES FIDELITY & GUARANTY COMPANY

In the case of *Bank of Huntingdon v. Troy Smothers and United States Fidelity & Guaranty Company*, 626 S.W.2d 267, (Ct. App. Tenn., 1981), a bank employee, over a span of sixteen years, stole money that he concealed through the processing of loans to himself and others. When those notes came due, that employee created other bogus notes to pay off the interest or loan balance due or to steal more money.

In filing a claim with its fidelity carrier, the Bank of Huntingdon claimed the balances due on the fictitious promissory notes plus the earned interest accrued as of the date of discovery of its employee's scheme. Conversely, that carrier, United States Fidelity & Guaranty Company, contended the bank was only entitled to recover under its bond the monies that actually went into the principal's pocket and not payment of any portion of the claimed loss that represented interest.

By USF&G's reasoning, because the principal's actions produced a "pyramid" effect whereby he embezzled funds to, in part at least, pay off previously created fictitious notes and interest thereon, such payments simply constituted money transfers on the books of the Bank of Huntingdon and involved no actual loss to the bank. Further, USF&G argued, such interest was not covered under the bank's bond which excluded from coverage thereunder "potential income."

In weighing the parties' respective arguments, the Tennessee Court of Appeals noted that the real issue before it was what constituted "Potential income". The court found that the money stolen from the bank's general funds by the principal, for whatever purpose, cannot be considered as potential income. As such, it essentially characterized such as purely "actual outgo." In doing so, the appellate court found no merit in the argument of USF&G that, since new funds were used to pay old interest due on old notes, the new funds must be purged of that portion repaid as interest. Instead, in finding that the interest claimed by the Bank of Huntingdon was covered under USF&G's bond, the court inexplicably held:

> We hold that 'Potential income, . . . not realized by the Insured' as stated in the exclusionary clause of the policy is that which the bank hopes to receive from the unrepaid money loaned, taken, embezzled or stolen from its general fund.

*Id.,* p. 270.

As should be clear, in this instance a court allowed itself to be swayed by the method of a thief's concealment (i.e., the processing of new bogus promissory notes to pay off loan principal and interest payment due, thereby keeping the earlier bogus loan from appearing on delinquency lists) in finding that something other than an insured's direct losses were covered by a fidelity bond. Instead, this court should have properly found this insured's direct losses were comprised solely of the money (asset) actually pocketed by the principal from the insured's accounts.

### B. PATRICK DEALER FINANCIAL – SCHAUMBURG, ILLINOIS

*Patrick Schaumburg Autos, Inc., v. Hanover Ins. Co.*, 452 F. Supp. 2d 857, 863, 869, 872-73 (N.D. Ill. 2006) involved the manager of an insured, Patrick Schaumburg Automobiles, a used car lot, allegedly overpaying for used cars he purchased from a wholesaler and underpricing used cars he sold to the wholesalers. The wholesalers, in collusion with the used car manager, would then sell those cars at auction, making a profit, which they shared with the used car sales manager.

In filing its claim alleging that employee's dishonesty, the insured contended the monies made at the auction were the measure of its losses. As such, it sought to recover from its fidelity insurer, Hanover Insurance Company, the difference between Black Book (market value) values of the cars sold and their initial purchase prices. Conversely, Hanover argued that the insured's direct loss, if any was sustained, equated to the difference between the original purchase price of each car involved in the scheme and the amount for which each vehicle was sold to the wholesaler, not the subsequent sale price at auction by the wholesaler. The insurer also argued that, because the questionable relationship between the insured's lot manager and the wholesaler caused both profits and losses to the insured, it was necessary to offset against the losses sustained any profits made as a result of the subject scheme.

In finding that the insured's direct losses constituted the difference between the overpayment amounts and market value amounts, the presiding court relied upon the market

values of the vehicles in question when they actually sold, when it should have measured those values as of the date of discovery of the principal's kickback scheme. The court found that what the insured overpaid for the used cars from the wholesaler constituted "a direct loss of covered property." What the court more properly should have concluded was that what the insured paid and what the insured received from the colluding wholesaler evidenced the actual depletion of assets. As such, if the insured realized a profit from that transaction, even a profit was less than would have been garnered from an arms-length transaction, no direct loss had been incurred by the insured, only a loss of potential income.

Again, as before, a court's miscomprehension between the method of concealment used by the principal and the losses, if any, that were incurred by the insured resulted in a convoluted and untenable finding that the loss was covered.

## *VIII. Summary*

While it is important to know that three out of ten people look for a way to steal, three out of ten people with steal if given the opportunity and four out of ten people will not steal even if given the opportunity, when evaluating the need for and types of safeguards to prevent theft, what is truly important is to avoid confusion and misunderstanding between what can be stolen (assets) and the different methods by which the theft is accomplished and concealed. Far too often people at all levels (insureds, lawyers and judges) confuse what can be stolen (assets) with methods of theft and methods of concealment, and this, in turn, leads to a misunderstanding of what is a covered loss and what is not a covered loss. It is fundamental to understanding fidelity coverage to know it is intended to cover only the direct loss of what can be stolen (assets) and that different methods of stealing assets and different methods of concealing the stealing of those assets do not give rise to additional coverage, either in terms of what is covered or in terms of the amount of coverage.

[1] *Bank Embezzlement Everyday in the Year*, N.Y. TIMES, Oct. 10, 1906, at 1.

[2] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 1 (2006).

[3] AICPA PROFESSIONAL STANDARDS, AU Section 316.06 (2005).

[4] 1996 REPORT TO THE NATION; *Association of Certified Fraud Examiners*, p. 12.

[5] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 10 (2006).

[6] *Id*. at 11.

[7] Doug W. Squires, *Problems Solved with Forensic Accounting: A Legal Perspective*, IV JOURNAL OF FORENSIC ACCOUNTING 1, 131 (2003).

[8] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 11 (1996).

[9] INTERNATIONAL ACCOUNTING STANDARDS BOARD, INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSS), IAS 38.3 (F.49(a)) (2007).

[10] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 12 (1996).

[11] STEVE W. ALBRECHT, FRAUD: BRINGING LIGHT TO THE DARK SIDE OF BUSINESS 19 (1995).

[12] *Id*. at 20.

[13] David Dranove & Michael L. Millenson, *Medical Bankruptcy: Myth Versus Fact*, HEALTH AFFAIRS JOURNAL March/April 2006, at 74.

[14] Robert A. Yaffee, PhD., *Profile of Pathological Gamblers Undergoing Treatment in the State of Maryland*, prepared for the Task Force on Gambling Addiction in Maryland, February 6, 1990.

[15] David Barboza, *U.S Hints Ex-Enron Accounting Chief Had Role in Fraud*, N.Y. TIMES, Oct. 4, 2002.

[16] STEVE W. ALBRECHT, FRAUD: BRINGING LIGHT TO THE DARK SIDE OF BUSINESS 27 (1995).

[17] *Civil Service Fraud in Tests for Police*, N.Y. TIMES, Oct. 3, 1919, at 26.

[18] DAVID WEISBURD, ET AL., WHITE COLLAR CRIME AND CRIMINAL CAREERS Abstract (1993).

[19] DAVID WEISBURD, ET AL., WHITE COLLAR CRIME AND CRIMINAL CAREERS 24 (2001).

[20] M. S. Beasley, SAS No. 99: *A New Look at Auditor Detection of Fraud*, IV JOURNAL OF FORENSIC ACCOUNTING 1, 6 (2003).

[21] AICPA PROFESSIONAL STANDARDS, AU Section 319.13 (2005).

[22] AICPA PROFESSIONAL STANDARDS, AU Section 319.110 (2005).

[23] *Id*.

[24] STEVE W. ALBRECHT, FRAUD: BRINGING LIGHT TO THE DARK SIDE OF BUSINESS 44 (1995).

[25] *Id*. at 47.

[26] M. S. Beasley, SAS No. 99: *A New Look at Auditor Detection of Fraud*, IV JOURNAL OF FORENSIC ACCOUNTING 1, 6 (2003).

[27] ACCOUNTING STANDARDS ORIGINAL PRONOUNCEMENTS 2002/2003 EDITION, III FINANCIAL ACCOUNTING STANDARDS BOARD, 1108 (2002).

[28] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 13 (1996).

[29] INTERNATIONAL ACCOUNTING STANDARDS BOARD, INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRSS) 44 (F.49(a)) (2007).

[30] WEBSTER'S NEW WORLD COLLEGE DICTIONARY 920 (Michael Agnes, ed., Wiley Publishing, Inc. 4th ed. 1913) (2006).

[31] *Id*. at 1401.

[32] *Id*. at 301.

[33] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 10 (2006).