INFERRING DISHONESTY: THE FIFTH AMENDMENT AND FIDELITY COVERAGE*

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Dishonest employees always have posed a problem for businesses. The average business may lose six percent of its annual revenues to employee fraud, and cumulatively the impact of employee theft on the economy is estimated to be $600 billion annually. *See* Association of Certified Fraud Examiners ("ACFE"), 2002 Report to the Nation on Occupational Fraud & Abuse, at ii, 4 (2002), *available at* http://www.cfenet.com/publications/rttn.asp. Although the average loss through employee embezzlement is $25,000, where computerized financial records or transactions are involved, the average loss increases nearly twentyfold. *See* National White Collar Crime Center, *WCC Issue: Embezzlement/Employee Theft*, at 2 (2002), *available at* http://nw3c.org/downloads/Computer_Crime_Weapon.pdf.

Insurers have responded by selling employee-dishonesty or fidelity policies, which reimburse the insured for its monetary loss from the dishonest or fraudulent acts of its employees (or others in positions of trust). When claims arise, most fidelity policies require the insured to submit a detailed, sworn proof of loss. The preparation of such a proof may require the insured to conduct a significant investigation into how the loss occurred and to monetize its claim.

Where there is patent embezzlement, such as where funds are improperly disbursed by the company and are ultimately found in an employee's personal bank account, insurers routinely pay claims with little dispute. When more complex claims are involved, such as when an employee and co-conspirators participate in an elaborate fraudulent scheme, insurers often question whether the entire loss claimed is covered, usually contending that some portion of the loss resulted from the exercise of poor business judgment, rather than from covered dishonesty. *See, e.g., Building One Serv. Solutions v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, No. 02-311-A (E.D. Va. Nov. 26, 2002) (Memorandum Opinion), *reprinted in* Mealey's Litig. Emp. Liab. Ins. Rep., at Sect. H (December 13, 2002). In such circumstances, insurers often refuse, absent litigation, to pay some or all of the loss.

In complex cases it can be difficult to establish "dishonesty" or the scope of the loss "resulting from" the dishonesty without an admission of dishonesty and a description of wrongdoing by the dishonest employee or a co-conspirator. *See, e.g.*, *FDIC v. Fidelity & Deposit Co. of Md.*, 45 F.2d 969, 974-76 (5th Cir. 1995). Such admissions are often hard, if not impossible, to obtain because of the potential criminal penalties and civil liability facing the wrongdoers. Whether in an informal investigation, coverage litigation, or criminal investigation or prosecution, the wrongdoer may refuse to tell all and instead may assert his Fifth Amendment privilege against self-incrimination. This poses a question of a failure of proof for the policyholder, since the wrongdoer is uniquely situated to disclose that the means or motives of the dishonest acts fall within the terms of fidelity insurance coverage.

Courts have responded to the risk that the insured would fail to establish the elements of coverage from the refusal of the wrongdoer to admit his wrongful acts by permitting a coverage-favorable inference to be drawn from the mere fact of the assertion of privilege. Given that the purpose of fidelity coverage is to protect the insured against the risk of loss from its employees' dishonest acts, this inference favoring coverage is as it should be.

Juries Appropriately May Consider the Wrongdoer's Invocation of the Fifth Amendment Privilege Against Self-Incrimination in Fidelity Insurance Coverage Cases

The privilege against self-incrimination is available in both civil and criminal cases. *See Baxter v. Palmigiano*, 425 U.S. 308, 318 (1976). It is generally true that a jury will not be permitted to draw an inference against a criminal defendant based on his or her invocation of the Fifth Amendment privilege. *See, e,g., Carter v. Kentucky*, 450 U.S. 288, 300 (1981); 18 U.S.C. § 3481 (2003) (criminal defendant's refusal to testify "shall not create any presumption against him"). Invocations of the Fifth Amendment privilege in civil cases do not necessarily have the same effect. The Supreme Court has recognized that "the Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them." *Baxter*, 425 U.S. at 318. The invocation of the Fifth Amendment may be presented to a jury, and the jury may consider its invocation as evidence that the act described in the question(s) to which the witness invoked the privilege took place. *See Libutti v. United States*, 107 F.3d 110, 124 (2d Cir. 1997) (holding that the witness's invocation of the privilege "made it more probable that [he] had committed the acts in question."); *Baxter*, 425 U.S. at 318 (stating that the "'[f]ailure to contest an assertion . . . is considered evidence of acquiescence . . . if it would have been natural under the circumstances to object to the assertion in question.").

In the context of a fidelity insurance coverage dispute, however, it is usually not a party to the suit that invokes the Fifth Amendment privilege, but a non-party witness, such as the dishonest employee or a co-conspirator of the employee. The concern in this context is

the possible prejudice of the party as against whose interest the jury draws the inference of the truth of the matter asserted in the question that was not answered on Fifth Amendment grounds. Notwithstanding the inability to cross-examine this "testimony," all Federal Circuit Courts confronting the issue have held that juries typically are permitted to make an inference from a non-party's invocation of the Fifth Amendment that the criminal act occurred. *See Libutti,* 107 F.3d at 121 (2d Cir. 1997); *RAD Serv. Inc. v. Aetna Cas. & Sur. Co.,* 808 F.2d 271, 275 (3d Cir. 1986)*; FDIC,* 45 F.3d at 978; *Cerro Gordo Charity v. Fireman's Fund Am. Life Ins. Co.,* 819 F.2d 1471, 1482 (8th Cir. 1987); *see also* George R. Fair*, Confessions, Convictions, and the Fifth Amendment,* 20 A.B.A. Brief 22 (Spring 1991).

In determining whether to admit a non-party's refusal to answer, however, courts do consider various factors in context under Rule 403, including (a) whether the witness is asserting the Fifth Amendment privilege for the purpose of harming a party, see *Cerro Gordo*, 819 F.2d at 1480-82; (b) whether the inference prejudicially would aid one party, see *Brink's Inc. v. City of New York,* 717 F.2d 700, 710 (2d Cir. 1983); (c) whether counsel effectively is testifying in place of the witness, see *Brink's*, 717 F.2d at 708; (d) whether the witness is a key figure in the litigation, see *Cerro Gordo,* 819 F.2d at 1480-82; (e) whether either of the parties have control over the non-party witness, see *Libutti*, 107 F.3d at 120-21; and (f) whether corroborating evidence exists with respect to the topic of the inference, see *RAD Serv*., 808 F.2d at 275 and *Cerro Gordo,* 819 F.2d at 1482 (holding that to support the inference a party would need corroborating evidence, but not "of the undeniable variety").

Applying these factors, courts have admitted, for example, an employee's invocation of the privilege and allowed the jury to draw the corresponding inference against the party employer, absent evidence that the employee had an intent to harm the employer by refusing to testify. *See RAD Serv*., 808 F.2d at 279-280. Although the majority of cases considering the issue involved a non-party witness who had a relationship with the party against whose interest the inference would be drawn, courts have held that such a relationship is not required in order for the jury to draw an inference of fact adverse to a party. *See Libutti*, 107 F.3d at 121-22.

Two cases have addressed this issue directly in the context of fidelity insurance, and both permit the jury to consider the non-party's invocation of the privilege and to draw an inference therefrom going toward establishing coverage. In *FDIC v. Fidelity & Deposit Company of Maryland*, the insured sought coverage for losses that arose out of a bank officer's fraudulent loan-making scheme. 45 F.3d at 971. At trial, several witnesses that received loans from the dishonest officer invoked their Fifth Amendment privilege in response to questions regarding the loans. In dismissing the insurer's arguments that the jury should not have been permitted to consider the witnesses' refusal to answer, the court stated that "the fact that the witness no longer serves the party in an 'official capacity' does not present a bar to requiring the witness to assert the privilege in front of the jury." 45 F.3d at 978. The court concluded that, since the insured had set forth corroborating evidence and the jury instruction had been proper, the jury properly could draw the inference that the employee engaged in dishonesty from the non-parties' invocations of the privilege.

Similarly, the Minnesota Supreme Court permitted a jury to draw the inference regarding an embezzlement loss. *See Ralph Hegman Co. v. Transamerica Ins. Co.*, 198 N.W. 2d 555 (Minn. 1972). The court affirmed the trial court's decision to allow the jury to draw an inference from a witness's assertion of the Fifth Amendment privilege in response to questions regarding the embezzlement, holding that "[i]f the jury could properly have been permitted to draw inferences in favor of [the employer] against [the employee] because of his assertion of privilege on its claim against him, there seems no sound reason why the jury should not be permitted to draw the same inferences in considering the substantially identical claim of [the insured] against [the insurer]." 198 N.W. 2d at 557-58. As the court explained:

> In this case the party prejudiced by the disclosure of the Fifth Amendment claim is not the party who asserted the privilege. However, appellant had agreed to indemnify plaintiff against loss resulting from dishonesty or fraud on the part of [the employee.] It had, therefore, assumed certain responsibility for [the employee's] acts of the kind involved here.

198 N.W. 2d at 557-58. Underscoring the court's conclusion was its holding that, through fidelity insurance coverage, the insurer agreed to accept liability for the employee's dishonest acts, and, therefore, the employee's statements (or assertions) made as part of or related to the dishonesty effectively were admissions against the insurer. 198 N.W. 2d at 558

Permitting such an inference is eminently fair in the light of the nature and purpose of fidelity insurance. The insurer sold insurance to protect against loss through employee dishonesty and, in selling such insurance, knew that it could be difficult for the insured in its proof to obtain direct testimony from the dishonest employee or other participants in a fraudulent scheme. Indeed, many such policies are labeled as "crime" coverage, which shows that the insurer naturally was aware of the crime context and by extension the possibility that the defalcator would invoke the Fifth Amendment. (It is also notable that there is not an examination-under-oath provision, which is sensible given that the insured is the innocent victim, but which indicates that insurers know how to protect themselves contractually when they choose to do so.) The insurer, therefore, has no reasonable expectation that it can avoid its coverage obligations when an employee or co-conspirator refuses to testify.

Consequently, it may be advantageous for an insured to take the deposition of the dishonest employee or co-conspirators. In such a deposition the witness may answer the questions posed or may assert the privilege against self-incrimination. Either way, the insured is likely to obtain evidence that will support its coverage claim. The insured should prepare its questions diligently and should confront the witness with whatever evidence has been developed to corroborate that the loss resulted from his or her dishonesty, including accounting records, contracts, and any statements of other witnesses to the dishonest acts. The insured should question the witness on all pertinent issues in detail to show with precision at trial the topics about which the witness invoked the privilege and, therefore, the specific facts the jury may infer as being true (by dint of the invocation of the privilege). (Of course, during such a deposition, the insurer may question the wrongdoer regarding the basis for the refusal to testify and the extent of the claimed privilege so that it later can ask the court to evaluate the propriety of the assertion of privilege and seek to compel testimony notwithstanding that assertion. *See, e.g., RAD Serv*., 808 F.2d at 278; *In re Keller Financial Services of Florida, Inc.,* 259 B.R. 391, 399-401 (M.D. Fla. 2000) (stating that the trial court must determine the propriety of the witness's assertion of the privilege according to the facts in a particular case)). Relatedly, the insured should not accept an offer by the insurer or the witness's counsel to stipulate that the witness will assert the Fifth Amendment privilege as to each question on the topic of the loss or risk losing the practical benefit of the coverage-favorable inference.

Whether the refusal to testify is in a formal deposition or an informal interview, the insurer should construe the refusal to answer as establishing coverage-favoring facts. *See, e.g., Lucas v. State Farm Fire & Cas. Co*., 963 P.2d 357, 361 (Iowa 1998) (holding that an insurer must draw every reasonable factual inference in favor of coverage). An insured should not be required to file suit simply to avail itself of this rule.

The failure of an insurer to draw such conclusions following the invocation of the Fifth Amendment privilege by the dishonest employee or a co-conspirator could give rise to an action for bad faith. *See* Marc S. Mayerson, *'First Party' Insurance Bad Faith Claims: Mooring Procedure to Substance,* 38 Tort Trial & Ins. Prac. L. J. 863 (2003).

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Fidelity claims can be challenging to prove absent the cooperation of the dishonest employee, cooperation that often is difficult to secure. The law recognizes, however, that an insured should not be deprived of coverage for employee-dishonesty losses simply because the dishonest employee refuses to cooperate and invokes the privilege against self-incrimination. By allowing the presentation to the jury of the malefactor's invocation of the privilege and permitting the jury to draw coverage-favorable inferences therefrom, courts appropriately have closed the gap in proof that insureds face in such circumstances. The same coverage-favoring inferences apply as well outside of the litigation context. Insurers, therefore, may not refuse to pay a fidelity claim on the basis of the alleged lack of direct testimonial proof of dishonesty due to an employee's or co-conspirator's refusal to provide testimony regarding the circumstances of the loss through the assertion of the privilege provided by the Fifth Amendment.

*Previously published in the Insurance Coverage Law Bulletin, April 2004, Volume 2, Number 3. Copyright 2004.