The Point of No Return: Terminating Employees for Dishonesty and Litigating Employee Fraud Claims

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Employee embezzlement and fraud is a widespread problem, costing Canadian employers hundreds of millions of dollars in losses every year. In Blaneys' March 2015 *Employment Update*, we canvassed several common "Red Flags" which may be indicative of employee dishonesty.[1] This article addresses the employer's response once evidence of employee dishonesty has come to light.

First Things First: To Terminate or Not to Terminate?

Typically, the employer will wish to terminate the employee for cause immediately upon obtaining strong evidence of fraudulent activity. The decision to terminate the employment relationship is a common and understandable response to such a discovery.

There are several reasons why employers seek to terminate immediately. The termination of the employment relationship immediately puts an end to the employee's defalcations, while also sending a strong message that the employer does not condone dishonest conduct. Moreover, the failure to terminate the employment relationship for a protracted period may adversely impact upon a future claim under the employer's fidelity insurance policy.

Employee theft is one of the few grounds for termination without notice in the common law provinces; as one trial court recently explained:[2]

More significantly, [the discovery of employee dishonesty] undermined the trust which was an essential ingredient of [the employee]'s relationship with [the employer]. Dismissal is justified where an employee's dishonesty violates an essential condition of the employment contract, breaches the faith inherent in the work relationship, or is fundamentally or directly inconsistent with the employee's obligations to his or her employer …

Employers are entitled to hold high expectations regarding the trustworthiness of their senior or managerial employees. When a senior employee's conduct reveals character traits that undermine the employer's trust in the employee, summary dismissal may be warranted …

This has been described as "revelation of a character flaw" … In Jewitt, Smith J. expressed the view that dishonest conduct will almost always justify dismissal, and the more serious and responsible the position held, the more that honesty must not only be inherent, but patent.

However, the employer must weigh its options carefully in coming to this decision. While employers should involve legal counsel from the outset of workplace fraud investigations, appropriate legal advice and guidance becomes even more critical as the employer gathers and assesses the evidence in coming to a decision on whether or not to terminate the employee.

The decision to terminate is not without its pitfalls. First and foremost, the employer may find itself the subject of a wrongful termination lawsuit. Further, if the employee is advised (or otherwise becomes aware) that he was, or will be, terminated for engaging in fraudulent conduct, the employee may swiftly move fraudulently-obtained assets beyond the reach of civil recovery efforts.

A key consideration in deciding *when* to confront and/or terminate an employee is whether the fraud investigation has ascertained what happened to the stolen funds, and whether there are likely to be any assets against which to recover. In certain cases, it is possible to commence recovery steps before the employee is even aware that he has been "found out" (including, for example, where fraudulent conduct is discovered after the employee has left the employer for other reasons, such as resignation or retirement). Given the element of surprise, such circumstances usually offer the best prospects for recovery.

Placing the employee on leave or administrative suspension pending further investigation of the alleged fraud may, in certain circumstances, constitute a reasonable (albeit temporary) fall-back position in preference to outright termination. An employer should review the terms of the relevant employment contract and the collective bargaining agreement (if applicable) with counsel prior to taking any action.

Offsetting the Loss: Fidelity Insurance

Many Canadian employers have obtained fidelity insurance (also known as employee dishonesty or commercial crime coverage) to protect themselves in the event of a loss occasioned by the fraudulent conduct of an employee. Generally, coverage under such policies is contingent upon providing prompt notice of the loss or suspected loss to the insurer. An employer should advise its broker in the event of a suspected loss occasioned by employee dishonesty, to ensure that it complies with the policy's condition concerning timely notice of loss.

Offsetting the Loss: Civil Recovery Actions

Depending on considerations such as: the size of the loss; possible coverage issues under the fidelity policy; and any applicable policy deductible, an employer may decide to pursue legal action against the employee. Such efforts may include:

- obtaining a *Norwich* production order against the defaulter's financial institution(s) or others, to trace funds that have been misappropriated, including into other assets. *Norwich* orders can also be used to identify beneficiaries of the fraud and other potential defendants whom the employer may wish to pursue;
- obtaining a *Mareva* injunction to freeze real and personal property; and,
- obtaining and registering a Certificate of Pending Litigation (CPL) on title to real property owned by the defaulting employee.

Most fidelity policies include conditions requiring the insured to take reasonable steps to mitigate the loss. Such steps can include pursuing a civil recovery action against the employee. Where the fidelity insurer is involved at an early stage, it may be possible for the employer to work in tandem with the fidelity insurer's recovery personnel. Prompt, well-executed legal action can result in substantial recoveries. [3]

Traditionally, an employer alleging fraud on the part of its employee had to prove its case to a higher standard than the usual civil standard of proof. However, the 2008 decision of the Supreme Court of Canada in *F.H. v. McDougall* suggests that an employer need only prove fraud on the part of its employee on a balance of probabilities, consistent with the standard of proof in other civil cases.[4]

Nevertheless, much like the decision to terminate or not terminate the employment relationship, the decision to pursue legal action is not without potential pitfalls.

First, the employer must carefully and dispassionately consider the strength of its case. An unsuccessful fraud claim will not only result in unrecoverable legal fees, but may also expose the employer to significant adverse costs sanctions. A dispassionate assessment of the employer's claim in fraud is an essential check on the risk that a fraud investigation will be compromised by tunnel vision. Most often raised in the criminal law context, tunnel vision occurs where an investigator searches solely for evidence confirming his initial theory of the case, and disregards evidence which contradicts that theory. As the Alberta Court of Queen's Bench observed:[5]

The least objective defence evidence was from [the employer's investigator]. I find that her investigation was not the fact-finding mission she indicated it was, but rather an exercise in case-building against [the employee]…

[The investigator]'s testimony at trial indicates that she was dismissive of any explanation that [the employee]offered. I find that she was not prepared to consider any context at all or the fact that the discrepancies in the overall context of the Service Excellence program was a massive undertaking. Furthermore, the failure of [the employer] to provide administrative and logistical support when it clearly should have done so for prudent management if nothing else, suggests to this Court that the investigation she headed was clearly case-building.

Second, the employer must determine if the defaulting employee is in possession of assets against which the employer might look to execute to satisfy a civil judgement. An asset investigation may be obtained to assist an employer in making this assessment. Further, if the employee's bank records can be obtained via a *Norwich* production order, the records may enable the employer to ascertain whether there are sufficient recoverable assets to justify undertaking a civil recovery effort. A motion for a *Norwich* production order need not be brought on notice to the employee, although the employer must have convincing*prima facie* evidence of wrongdoing.

Third, a fraud recovery action runs the risk of creating adverse publicity for the employer, by bringing attention to the fact that the employer's controls were compromised or circumvented. The employer must weigh the potential reputational damage associated with disclosing the fraud in question with the potential recoveries it might obtain from its defaulting employee.

Given these potential pitfalls, an employer should retain counsel with experience in litigating such claims. Where an employer has also submitted a claim in respect of the loss with its fidelity insurer, that insurer may be in a position to recommend experienced recovery counsel and/or to pursue recovery jointly with the insured under a mitigation agreement.

The Boomerang Effect: Wrongful Termination Claims and Counterclaims

Just as an employer must decide whether or not to commence legal proceedings against its defaulting employee, the employee must decide whether or not to commence legal proceedings against his former employer. Often, a wrongful termination claim is advanced by the employee as a counterclaim to the employer's fraud recovery action, perhaps with the employee hoping to use the counterclaim as a "bargaining chip" in settlement negotiations. As a practical matter, the evidentiary strength of the employer's fraud claim almost inevitably dictates the likely result of the employee's wrongful termination counterclaim. However, the existence of a wrongful termination counterclaim can sometimes inject an element of unpredictability into the litigation. If the value of the fraud pales in comparison to the value of the wrongful termination counterclaim, the employer may even find itself on the defensive, notwithstanding that it was the victim of the fraud.

These risks reinforce the importance of performing an early, dispassionate assessment of the employer's claim in fraud prior to the commencement of legal proceedings, as well as retaining legal counsel who is prepared to handle the challenges arising from the investigation of workplace fraud and the prosecution of civil recovery actions.

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[1] C. McKibbin, "Tell Tale Signs: The Red Flags of Employee Fraud"*Employment Update* (March 2015). [http://www.blaney.com/sites/default/files/TellTaleSignsEmployeeFraud_CMcKibbin_2015.pdf]

[2] *Molloy v. EPCOR Utilities Inc.*, 2015 ABQB 356 at paras. 209-211.

[3] See, for instance, the seven-figure recovery obtained by the victim of a civil conspiracy in *Spartek Systems Inc. v. Brown,* 2014 ABQB 526.

[4] *F.H. v. McDougall*, [2008] 3 S.C.R. 41 at para. 40.

[5] *Chapell v. Canadian Pacific Railway,* 2010 ABQB 441 at paras. 63 and 67.