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American Institute of Certified Public Accountants. Professional Liability Insurance Plan Committee

ACCOUNTANT'S
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NEWSLETTER

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Early Reporting of Claims: The Insurer's Perspective

By Dennis Bissett, A.V.P.
Crum & Forster Managers Corp. (Illinois)

In the last quarterly "Newsletter" we discussed the prompt reporting of claims and the benefits that accrue to the policyholder. Briefly stated, the issue is the protection of your insurance coverage, and potentially, your firm and personal assets.

Early notice of a claim, or potential claim, is also of benefit to an insurer. From a claims department standpoint, there are several practical advantages to early notice of a claim, or situations that could develop into a claim. Some of these are:

1. **Prompt Investigation** — Prompt notice to the insurer greatly assists the investigatory process. Upon receipt of a claim, the claims technician contacts the insured for an analysis of the allegations. The technician will then speak with the person(s) involved in the engagement. Records are readily available, memories are fresher, more information and better information is developed while the events are fresh in the practitioner's mind.

2. **Planned Defense** — Early notification of a claim or incident will allow the insurance carrier and accountant to prepare a prompt joint defense to the allegations. After the filing of a lawsuit, the defense is somewhat more structured and bound by formal discovery and court procedures. However, early notice allows for more timely and informal handling, and provides an environment where the accountant and claims person are better able to review documents, request additional information or interview others at their discretion.

3. **Client Relations** — After discussion with the insured, the insurance company will contact the client, or other claimant, if warranted. While some claims are of questionable merit as to the accountant's alleged legal liability, the fact remains that most claims have a value, i.e., that some professional error was made and that monetary damages were incurred. This is the purpose of insurance, protection from errors or omissions. Early notice of such situations allows the insurer to contact the client. While the objective of such contact is to secure information, an added benefit is to reassure the client that his claim is receiving proper attention. If ignored, all too often clients will engage an attorney. When that occurs, costs and time of settlement are often increased. The knowledge that the accountant and the insurance carrier are working with the client toward a united goal allows many claims to be resolved

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amicably and without litigation. Additionally, you may keep valuable clients.

4. **Early Expert, Legal Representation** — Early notice affords the opportunity for review and counseling by accounting and legal professionals. If warranted, an early professional-client privilege can be established early. You will know that the case involving you and your firm is receiving detailed and competent attention. Such early expert retention is of significant benefit on larger damage claims or more complex litigation.

5. **Document Protection** — Prompt notice insures that key documents are retained and protected. This may seem self-evident, but cases have been compromised by inadequate document protection. In one major case, an insured's office administrator destroyed primary defense documents in a regular records purge. A skilled plaintiff's attorney can make such an event very difficult to defend. Early advice of a claim identifies relevant documents and assures that they are protected.

Early notice affords the opportunity for review and counseling.

6. **Insurance Coverage Protection** — Most professional liability insurance policies contain provisions that mandate prompt notice of claims. Failure to do so could, in some situations, be held to be a violation of policy provisions and could negate your insurance coverage. This is a situation that can be precluded by the practitioner's timely notice to the carrier of claims or potential claims. Even totally spurious allegations should be reported immediately to your carrier.

There is an axiom within the insurance industry that claims do not get better with age. While prompt notice of claims has many benefits to the insurer, there is also significant benefit to the insured.

The insurance protection you have purchased is working for you. You and your firm are protected up to the limit of your liability. As one recently sued practitioner said, "My partners and I feel much better knowing we have coverage for this."

If you have any questions, please feel free to contact me at 1-800-879-4272.

Professional Liability Insurance: Price vs. Value

By Jonathan W. Kimnach, New Business Account Representative Rollins Burdick Hunter.

November 20, 1989, a date many accounting firms will not forget. On that date, numerous accounting firms nationwide were issued notices of non-renewal as of 12/21 at 12a.m. for their professional liability coverage from a prominent insurance company that was forced into liquidation due to lack of sufficient capital. Accountants were provided with a brief one month period in which to find replacement coverage and they were also notified that all claims or incidents must be reported by 1/19/90. What had been purchased as coverage for protection and "peace of mind" was now a nagging problem. As unsettling as this scene may seem, it is not the first incident in 1989, as two other regional insurance carriers also met the same fate, leaving many other accounting firms searching for coverage in a like manner.

Today, accountants have the luxury of multiple sources from which to procure their liability coverage. Many are lured by price alone, rather than making sure they are getting the basic protection (peace of mind) they seek. When purchasing coverage, one should keep three elements in mind: coverage, stability and commitment.

Many new insurers attract business through discount prices. These companies will advertise that they offer a broad form claims-made accountants' liability insurance contract, but prices are often so low one must ask the question, "How can they do this?" Many times the answer is "They don't." Even though most of the new carriers did not actually experience the claims crisis of the 80s, they are aware of the exposures which face them and reduce coverage by using various exclusions. If one carefully reviews the policy, the exclusions section may actually be longer than the coverage description. Audit services, SEC services and work performed for financial institutions are often excluded. Many times only three years of prior acts coverage will be provided regardless of how many years the firm has maintained liability insurance. The price may seem right and it may very well be, for the limited amount of coverage actually provided.

Another aspect which

should always be considered is the stability of a carrier. Many new carriers will claim that they are inexpensive because they are not paying out on past claims like established plans such as the AICPA sponsored Plan. This is true because they haven't been around long enough to pay claims. Could it be that they don't have the experience to know how much premium to charge in order to pay claims and still remain solvent? Such was the case recently with two popular liability insurers in the south and west. One should take the extra time to explore the insurer's risk rating, such as Best's Reports, as stability and cost of coverage often go hand-in-hand.

> Many new carriers will claim they are inexpensive.

One of the most important and often overlooked factors in selecting an insurer should be commitment to the market. If a company left the market once before, one has to wonder will it leave again? As we discussed earlier, many new carriers will build a book of business based on low prices. If payouts on claims rise faster than premium collected, the company will often pull out of the market and issue non-renewal notices to their insureds. Often a new carrier will state the company has been writing liability insurance for over 40 years. This may be true, but how long has the insurer been writing accountants' liability coverage? Accountants may be sold on the stability of the parent company of their carrier, but if the parent company decides that the accountants' market is not profitable, they may very well pull out and focus on other profitable lines of coverage.

Today, accountants have multiple sources for liability insurance. A prudent purchase will come only after determining the scope of coverage, stability and commitment of an insurer. A low price may seem attractive, but without quality, the accountant may not be purchasing what he intended to buy in the first place — protection and peace of mind.

Loss Prevention Course On Tax Malpractice Claims Available

Completed by Crum & Forster Managers Corp. (Ill.) in cooperation with the Professional Liability Insurance Plan Committee, *Tax Malpractice Claims and How to Prevent Them*, is a new 39-minute videotape that alerts CPA's to danger signals, typical tax situations that can lead to claims and how to prevent them, and six specific steps that can protect tax accountants from lawsuits. The price of the tape (118600), including workbook, is $69.00, with additional workbooks (118610) at $34.50 each. Recommended CPE credit, requiring completion of the accompanying examination, is 4 hours.

To order, simply call the Order Department of the AICPA at 1-800-343-6961. In New York State, call 1-800-248-0445.

PLIP Committee Announces Important Coverage Extension

The AICPA's Professional Liability Insurance Plan committee is keenly aware of the increasing number of insureds under the Plan who are becoming more actively involved in trust administration. The Committee also has learned that a number of insureds under the Plan are unaware that, to date, coverage for such activities has not been afforded under the accountants' professional liability policy issued by Crum & Forster. With this in mind, the Committee has worked with Rollins Burdick Hunter, the Plan's broker and administrator, and Crum and Forster, the Plan's underwriter, to address the problem.

The Committee is pleased to announce that all new and renewal policies issued by Crum & Forster after September 1, 1989, automatically will include a Trustee Endorsement that addresses coverage for accountants who serve as a trustee. This endorsement will be attached to all policies at no additional cost to insureds, and will provide a limit of $250,000 for trust-related activities irrespective of the limit of liability for other accounting services.

The Trustee Endorsement amends several of the policy's provisions. The insuring clause itself contains two key changes. It extends the coverage to include not only compensatory damages caused by acts, errors or omissions when the insured accountant is performing professional accounting services for others, but also when he or she is performing as a trustee. The

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insuring clause is also amended to reflect that trustee coverage is subject to the policy's other exclusions and does not cover insureds who serve as trustees for pension or profit sharing plans that are subject to ERISA.

Several of the policy's exclusions have been amended in light of this coverage extension.

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Exclusion (B) has been amended to reflect that an insured's activities as a trustee are no longer excluded under the policy. Exclusion (H), which precludes claims arising out of professional accounting services performed for any organization, corporation, company, partnership, person, operation or entity, (other than the named insured), when such services include the sale or solicitation of securities, real estate or other investments, has been amended to also apply when the insured is acting as a trustee. Exclusion (I) has been amended to preclude coverage when the insured, in his or her capacity as a trustee, receives a fee or commission prohibited by the AICPA's rules of conduct. Exclusion (K), which generally precludes coverage for claims arising out of professional accounting services for any organization or entity while an insured is an official thereof, has been amended to permit coverage when the insured is a trustee of the organization or entity.

The provisions of the Trustee Endorsement require insureds to notify Crum & Forster in writing of claims arising out of their activities as trustee during the policy period in order for the policy to apply. The Endorsement also provides that the Extended Reporting Period applies to claims involving an insured accountant's activities as trustee.

The Committee believes that the extensions afforded under the trustee Endorsement are a significant enhancement of the plan's professional liability coverage. Those accountants whose practice includes serving as trustee, or those considering expansion of their practice into this area, will know that their professional liability policy has addressed the exposures arising out of such activities.

Additional questions about this coverage extension should be directed to Rollins Burdick Hunter.

Toll-free Claims Line Now Available

Crum & Forster Managers Corp. (Ill.), the underwriter for the AICPA Professional Liability Insurance Plan, has recently installed a nationwide toll-free telephone system. The purpose is to encourage insureds to call CFM at any time with information or questions about their claims. No cost will be incurred by the caller.

Please note that claims cannot be reported to Crum & Forster via telephone. The insurance policy specifically states that reports of claims must be written. However, if you are presented with a claim, or potential claim, and want to discuss reporting or other aspects, please feel free to use the toll-free number. Of course, insureds with existing claims are encouraged to call the claims technician handling their case at any time.

The Crum & Forster Managers Corp. (Ill.) claims toll-free number is 1-800-879-4272.

Case Reviews

Bank Audit: U.S. District Court, Pennsylvania

Internal workpapers and other documents generated during government's examination of bank not protected by official information privilege.

The Federal Savings and Loan Insurance Corporation ("FSLIC") sought an award of damages against the former directors, officers, attorneys and accountants of a federal savings and loan institution. In a pre-trial procedural matter, a U.S. District Court judge recently issued a memorandum opinion relating to discovery of internal working papers and other documents generated in a governmental examination of the bank. The accountant defendants had requested the documents, but the government refused to produce them claiming the "bank examination privilege." See 12 C.F.R. §505 *et seq.* The Court discussed both the "bank examination privilege" and the "official information privilege" and ruled that the documents were not protected by either. The government was ordered to produce the requested documents so that the Special Master could review them to determine whether they were relevant.

The "bank examination privilege":

The basis of the government's claim of "bank examination privilege" was 12 C.F.R. §505 *et seq.* The government argued that the documents represented information of the Board as provided by 12 C.F.R. 505.2. As such, the information was not subject to disclosure under 12 C.F.R. 505.5 according to the government. The Court, however, did not agree. The "bank examination privilege" is not an independent evidentiary privilege. Rather, the regulations relied on by the government are the implementing regulations for the Federal Home Loan Bank Board's Freedom of Information Act ("F.O.I.A."). See Denny v. Carey, 78 F.R.D. 370 (E.D.Pa. 1978). Under those implementing regulations, reports prepared by banking regulatory bodies are beyond the scope of the F.O.I.A., but that exemption is not an independent evidentiary privilege. Rather, the F.O.I.A. exemptions only allow withholding such documents from the public generally.

> The "bank examination privilege" is not an independent evidentiary privilege.

The Court noted that the government had cited Lincoln Savings & Loan Ass'n. v. UN Financial Corp., 120 F.R.D. 3 (D.D.C. 1988) for the proposition that the "bank examination privilege" is an independent evidentiary privilege. However, the Court distinguished Lincoln, noting that case involved an action between two private parties. Also Lincoln did not address the issue of whether production of documents would be required, but rather addressed the criteria for releasing documents.

The Court concluded that the "bank examination privilege" is not an independent evidentiary privilege and did not protect the documents requested in this case.

The "official information privilege":

The Court then noted that the government argued that the policies supporting the "bank examination privilege" were similar to policies supporting the more general "official information privilege." Therefore, the Court addressed the issue of whether the government could withhold the documents pursuant to an "official information privilege." The primary rationale for the "official information privilege" is that the "effective and efficient governmental decision making requires a free flow of ideas among government officials and that inhibitions will result if officials know that their communications may be revealed to outsiders." See In re: Franklin National Bank Securities Litigation, 478 F.Supp. 577, (E.D.N.Y. 1979). A secondary rationale established by the Franklin court is that the judiciary should not attempt to probe the mental processes of governmental officers.

Under these rationales, the privilege properly applies only to expressions of opinion or recommendations. It does not apply to purely factual material. Furthermore, even as to opinions and recommendations, the privilege may not apply. Factors to be considered in determining whether it applies are: "(i) the relevance of the material sought to be protected; (ii) the availability of other evidence; (iii) the "seriousness" of the litigation and the issues involved; (iv) the role of the government in the litigation; and (v) the possibility of future timidity by government employees who will be forced to recognize that their secrets are violable." See Franklin, at 583. Thus, the issue is to be determined on a case-by-case basis by considering the competing interests.

> The official information privilege" does not protect the documents from production.

Following consideration of the factors set forth in Franklin the Court concluded that the documents may directly relate to the circumstances at issue in the case, (the Special Master would review the documents for relevance) and the documents were not available from any other source. The Court also noted the case involves important and serious issues, including claims for over one-half billion dollars. Particularly

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persuasive was the fact the the government was the plaintiff in the case. As plaintiff, the government has the obligation to produce the documents which may assist the defendants in their preparation of the case for trial. See United States v. Reynolds, 345 U.S. 1 (1953). The cases cited by the government did not support the claim of privilege because those cases did not involve the government as a party. See, e.g. Colonial Savings & Loan Ass'n. v. St. Paul Fire & Marine Insurance Co., 89 F.R.D. 481 (D.Kan. 1980). Lastly, any possible chilling effect from the production of these documents was outweighed by the other factors in this case.

The Court concluded the "official information privilege" does not protect the documents from production, and ordered the documents be produced for the Special Master so he could review them for relevance.

In re: Sunrise Securities Litigation, No. 655, U.S. D.C. Eastern District of Pennsylvania, 1/9/90.

Audit: New York

Third-party claims allowed where Credit Alliance elements satisfied.

Purchasers paid $115 million for the assets of a corporation. Later, they filed an action for damages against the sellers and their accounting firm alleging the price paid was $30 million more than it should have been. The complaint alleged fraud and negligent misrepresentation as to the accounting firm which had been the seller's auditor. The accounting firm had certified the seller's financial statements as accurate and confirmed the value of assets involved. The Court stated that the record established that the financial statements were misleading and that the value of the assets had been substantially inflated.

The accounting firm filed a motion to dismiss the claim. The trial court concluded that the plaintiffs had not established a relationship between the firm and the plaintiffs giving rise to a duty. Therefore, the court dismissed the claims against the accounting firm. The plaintiffs appealed.

> The accounting firm had certified the seller's financial statements as accurate.

Held: The Court found for the plaintiffs and reversed the order of dismissal thereby reinstating the claims against the accounting firm. The plaintiffs were required to satisfy the necessary factors as set forth in Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 493 N.Y.S.2d 435 (1985): 1) the firm's awareness that the reports would be used for a particular purpose; 2) the firm's awareness that known parties intended to rely on the reports; and 3) the firm's conduct linking them to the parties and indicating the accountants understood the parties intended to rely on the reports.

Analyzing the complaint in view of these factors, the Court concluded that the plaintiffs satisfied all three factors. First, the firm was aware that their client intended to sell the assets. The client requested the audit and informed the firm that a sale was being considered. Furthermore, the purchasers (plaintiffs herein) told members of the audit team personally that they were considering the purchase.

Second, the firm's audit team met with the purchasers, discussed the audits with them, knew the purchasers would rely on the financial statements to determine an appropriate price, and knew the audited financial statements would be incorporated by reference into the representation and warranty section of the purchase agreement.

Third, the firm's conduct established a bond between the firm and the plaintiffs. Several meetings between the audit team and the purchasers had taken place. The Court concluded the firm's services had been extended to a known group with definable limits rather than an unresolved class of persons. See White v. Guarente, 43N.Y.2d 356 (1977).

> The plaintiffs were required to satisfy the necessary factors as set forth in Credit Alliance.

Having concluded the three elements of Credit Alliance had been satisfied, the court reinstated the complaint against the accounting firm.

John Blair Communications, Inc. v. Reliance Capital Group and Touche Ross & Co., No. 38220, Supreme Court of New York, 1/11/90.

Audit: Tennessee

Tennessee applies the foreseeability standard of §552 of the Restatement (Second) of Torts to third-party liability.

Accounting firm was retained to audit the annual financial statements for a client. The client was in the business of manufacturing water heaters and purchased steel on credit from another corporation (plaintiff herein). When the firm's client failed to pay amounts owing to the corporation on the purchase of the steel, the corporation filed suit against the firm alleging negligence in the preparation of the audit. Following trial, a jury returned a verdict for the corporation awarding damages in the amount of $500,000. The firm filed a motion to have the judgment set aside, or in the alternative, for a new trial. The trial court, ruling for the accounting firm, granted the motion for judgment notwithstanding the verdict, and conditionally granted a new trial. The corporation appealed.

Held: The Court reversed the judgment notwithstanding verdict, and remanded the matter for a new trial. As to the issue of whether the trial court erred in granting judgment notwithstanding the verdict, the Court noted testimony by two of the corporation's credit managers indicated that the client had been a problem account. Nevertheless, the jury evidently believed the witnesses testimony that the risk of selling steel to the client on credit was worth taking in light of the audited financial statements. On appeal, the Court is required to determine if some material evidence supports the jury verdict. See Holmes v. Wilson, 551 S.W.2d 682 (Tenn. 1977). The Court found at least some material evidence existed to support the jury verdict. Therefore, the trial court erred in granting judgment notwithstanding the verdict.

The Court then ordered a new trial noting that the trial court found the weight of the evidence was in the firm's favor on the issues of reasonable reliance, proximate cause, assumption of risk, and contributory negligence.

> The firm argued that an accountant's only duty is to those in privity with the accountant.

Next, the Court considered three issues raised by the firm as to alleged errors by the trial court. First, the firm argued the cause of action was based on an injury to a person (the corporation being considered a person in the eyes of the law), and that it was therefore barred by the one-year statute of limitations. The trial court had ruled that a three-year statute of limitations applied to the cause of action. The Court considered whether the injury was to a "person" thereby invoking the one-year limitation, or was an injury to "property" thereby invoking the three-year limitation. See T.C.A. §§28-3-104(a) and 28-3-105(1). Whether the injury was to property depends on the gravamen of the complaint, and is not limited to physical injury to property. See Vance v. Schulder, 547 S.W.2d 927 (Tenn. 1977). The injury here was a financial loss and was determined by the Court to be to "property." Therefore, the action was subject to the three-year statute of limitations and was not barred.

Second, the firm argued that the trial court applied an incorrect legal standard for accountants' liability to third parties. The trial court found that the "reasonably foreseeable" standard of Touche Ross & Co. v. Commercial Union Ins. 514 So. 2d 315 (Miss. 1987) applied. The firm argued that an accountant's only duty is to those in privity with the accountant. See Delmar Vineyard v. Timmons, 486 S.W.2d 914 (Tenn.App. 1972). The Court found that Delmar Vineyard was not controlling for three reasons: 1) Delmar Vineyard did not involve an accountant's liability to third parties; 2) a Tennessee statute (T.C.A. § 29-34-104 provides that privity is not required to maintain an action for property damage on account of negligence; and 3) several persuasive cases had applied §552 of the Restatement (Second) of Torts as the appropriate legal standard for a professional's liability to third parties for negligent misrepresentations. See Stinson v. Brand, 738 S.W.2d 186 (Tenn. 1987). The Court also found the reasoning in Raritan River Steel Co. v. Cherry, Etc., 332 N.C. 200, 367 S.E.2d 609 (N.C. 1988) to be persuasive. Raritan, which was factually similar to this case, reasoned that the §552 standard constituted an acceptable middle ground between the "privity" approach and the "reasonably foreseeable" approach. Also, Comment (h) of §552 was considered noteworthy by the Court: "It is enough that the maker of the representation intends it to reach and influence either a particular person or persons, known to him, or a group or class of persons. . . . It is enough, likewise, that the maker of the

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representation knows that his recipient intends to transmit the information to a similar person, persons, or group." Restatement (Second) of Torts §552 Comment (h) (1977). The Court concluded that the appropriate standard is that expressed by the Restatement and comment (h).

Bethelem Steel Corporation v. Ernst & Whinney, No. CA No. 861, Court of Appeals of Tennessee, 11/21/89.

Practice Management

Rule 102: New Interpretation Issued

A new interpretation was recently issued by the AICPA relating to Rule 102 of the Code, which provides as follows:

> "In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

This rule applies to all accounting engagements. The new interpretation recently issued by the AICPA relates to the conflicts of interest clause of the rule. Interpretation 102-2 provides that a conflict of interest may result where an accountant performs professional services for either a client or an employer and the accountant or the accountant's firm also has a significant relationship that could be viewed as impairing the member's objectivity. Such conflict can result from a significant relationship with another person, entity, product, or service. However, the rule does not prohibit the performance of professional service if the client, employer, or other appropriate parties consent after full disclosure as to the potentially conflicting relationship. Any disclosure as to the relationship must, in turn, be given only where Rule 301 can be observed. Rule 301 proscribes disclosure of confidential client information.

It should be noted that where independence is required by Rule 101 in connection with a particular engagement, disclosure and consent cannot be used to eliminate the requirement for independence.

The other interpretation issued by the AICPA for this rule, Interpretation 102-1, relates to the misrepresentation clause of the rule. Under this interpretation, any false and misleading entries in the financial statements or records of an entity will be considered a misrepresentation where a member knowingly makes, or allows or directs another to make, such false or misleading entries.

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