1991

Accountant's Liability Newsletter, Number 26, Fourth Quarter 1991

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

Number 26 Fourth Quarter 1991

Accountants' Liability Newsletter

Accountants Liability In the 1990s

By Dan L. Goldwasser
Solinger Grosz & Goldwasser
New York

Late Breaking News for 1992

- For the fifth consecutive year, no rate increase.
- Premium financing rate at 7.50% A.P.R.

Introduction — Overview of Accountants Liability

Professional liability claims against accountants have been rising sharply since 1970, following the courts' recognition of civil liability actions based upon the anti-fraud provisions of the federal and states securities laws. The financial pressures on financial institutions and commercial enterprises for the past two decades also caused many lending institutions and business enterprises to discard their prior reticence toward asserting claims against their professionals and this, in turn, accelerated the increase in claims against accountants.

Traditionally, claims against accountants have tended to run in cycles, with a heavy incidence of claims coming in the wake of periods of economic distress. Following the recession of 1981-1982, there was a surge in such claims which hit a crescendo in the second half of 1984. The current economic slowdown is likely to be felt much earlier than that of the early 1980s because of the relatively large amount of debt that most companies were carrying prior to entering into the current recession. Thus, one should expect to see a large increase in the number of claims against accountants beginning in the early part of 1992.

The great storm that has been brewing for the past three or four years involves claims that have been and will be asserted against accounting firms arising out of the failure of the nation's savings and loans institutions. Current indications are that, in total, there will be over a hundred such claims, of which only approximately one quarter have been asserted to date. In addition, in the past year, there have been a number of commercial bank failures which could give

continued on page 2

AICPA Professional Liability Insurance Plan

In This Issue

Articles

Features

ROUTE TO

☐ ____
☐ ____
☐ ____
☐ ____
☐ ____
☐ ____

rise to even further claims against accountants.

The savings and loan claims are particularly dangerous to the accounting profession, not only because of vast sums of money that were lost in the savings and loan debacle, but also because these claims are being brought by the RTC and the FDIC, both of which are well financed and have hired extremely capable legal counsel to assert their claims. In addition, the nation's taxpayers are understandably upset at the increased burden they will have to shoulder as a result of the savings and loan debacle and the courts are not unmindful of this general feeling. Accordingly, it is highly likely that many legal issues that are important to the accounting profession will get litigated in the resulting savings and loan cases and that many of these will be decided against the accounting profession. This is particularly unfortunate in that these decisions will be applied against the accounting profession for years to come. Thus, one of the side effects of the savings and loan debacle is that it is likely to generate a lot of "bad law."

Claims against accountants arising out of the savings and loan debacle will probably reach their peak sometime in the middle of this decade. Because these claims involve such large sums of money, they are likely to be defended vigorously. Although there has been some indication that the defendants in these suits will seek to settle them at an early stage, the chances are that most accounting firms, because of their limited amount of professional liability insurance, will try to settle all of their claims of this nature on a global basis so that they can avoid the possibility of exhausting their insurance coverage before all claims have been resolved.

Unfortunately, the available liability insurance for all major accounting and law firms is relatively small in terms of the amounts being sought by the FDIC and the RTC. Thus, there is

Liability *continued from page 1*

a distinct possibility that the entire professional liability insurance pool could be exhausted through these cases and once exhausted may never be replenished or at least not replenished on a basis sufficient to provide the same extent of coverage that exists today. Further, there is a possibility that the firm which waits until the very end to settle its claims may find itself with an insolvent insurance pool. Although this may seem like a doomsday scenario, it cannot be wholly ruled out.[1]

No one, not even (or particularly) the plaintiffs' bar, wants to see the demise of the accounting profession or the professional liability insurance coverage for accountants. Virtually all have realized the vital role played by accountants in facilitating the extension of credit which is so vital to commercial life in this country. Nevertheless, the savings and loan debacle is likely to result in claims which threaten the existence of certain of the larger accounting firms. Moreover, literally hundreds of other firms are likely to succumb to the economic pressures arising out of the current recession and the subsequent slow economic recovery. These developments could prompt a new wave of tort reform in the middle part of this decade which could give the accounting profession further protection so that it can carry out its important catalytic function.

There are already some early signs that the courts are starting to react to the extremely hostile legal environment in which accountants and other corporate defendants are being placed. Perhaps the best example of the courts' reaction is seen in the trilogy of decisions recently rendered by the U.S. Supreme Court adopting

[1] Editor's note: Under this scenario, the author is suggesting the reemergence of the insurance crisis of 1985-86 in which the sources of insurance declined, limits of liability reduced, and premiums skyrocketed dramatically.

the statute of limitations provisions found in Section 13 of the Securities Act for all civil damage claims brought under Section 10(b) of the Securities Exchange Act of 1934. Not only did the Supreme Court adopt this relatively short statute of limitations, it also chose to apply it retroactively. This will require the dismissal of a large number of claims which are currently pending.

In addition, the Supreme Court has also accepted for review the question of whether the statute of limitations found in Section 13 of the Securities Act can be circumvented by the plaintiffs simply alleging violations of the federal RICO statute based upon alleged violations of the federal securities laws. One can never be sure as to how the Supreme Court will react; however, its willingness to apply Section 13 on a retroactive basis certainly seems to indicate that the Court is not likely to allow its ruling to be circumvented simply by pleading a RICO violation. To be sure, the Supreme Court as well as all of the lower courts have been less enthusiastic to the use of the RICO statutes in a wide variety of commercial fraud cases.

Perhaps another sign of the courts' disposition is the case of Bily v. Arthur Young & Company which is now being considered by the California Supreme Court. Up and until now, the appellate courts in California have adopted the "foreseeability" doctrine pursuant to which an accountant can be held liable on a negligence standard to any person whose reliance upon the accountant's report was reasonably foreseeable. California currently is only one of four states that have adopted this approach, with all other states opting for the more conservative privity or Restatement doctrines. Should the California Supreme Court in Bily choose to abandon the "foreseeability" doctrine, this will certainly be a strong sign that the pendulum of law is starting to move back to-

Liability *continued*

Mr. Goldwasser is a Senior member of Solinger Grosz & Goldwasser, P.C., a New York City law firm, which represents the New York State Society of CPAs and approximately 110 CPA firms. Mr. Goldwasser is actively involved in the development of defensive loss prevention techniques/practices for CPAs. This article represents the initial installment of a series of articles that Mr. Goldwasser has contributed to the Newsletter, sections of which may have previously appeared in other periodicals or presentations by the author.

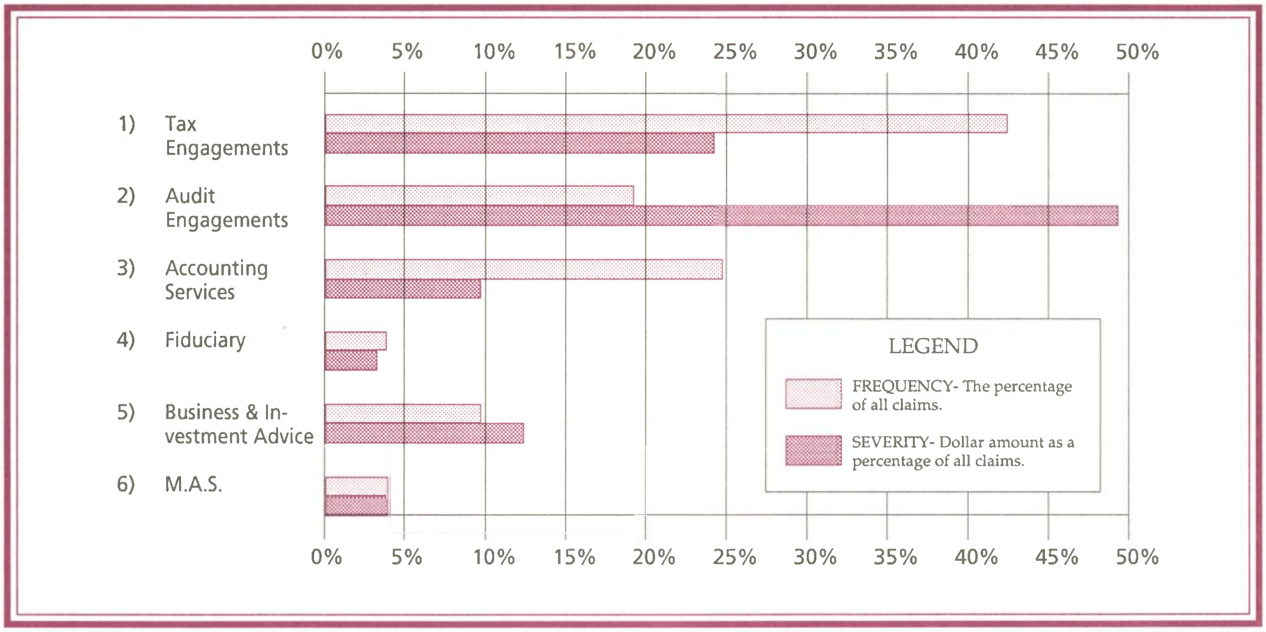
ward limiting civil liability exposure.

In the legislative area, there are few signs of tort reform. At this point, four states have adopted privity statutes, limiting those persons who may assert a negligence claim against accountants. Although legislation has been introduced in many other states, there seems to be no great momentum at present to pass this type of legislation.

For several years, the AICPA has been sponsoring RICO reform legislation which has been joined in by several other business groups. Although numerous such bills have been considered by Congress, none have been passed and the prospects for such legislation do not seem a high priority in the current Congress.

Similarly, the AICPA and other accounting organizations have been seeking for some time to have the various state legislatures adopt legislation limiting the application of the joint and several liability doctrine in cases against professionals. Whereas some states have adopted this type of legislation with respect to medical malpractice, none have adopted it for cases asserted against accountants, lawyers or corporate officers and directors. The fact is that there is very little sympathy in the various legislatures for this type of legislation which is vehemently being opposed by the trial lawyers. It will take a major litigation crisis to cause this type of legislation to be adopted, a crisis which we are likely to see in the middle part of this decade. Those persons who advocate this type of restrictive legislation should, however, begin to plan their legislature programs now so that they can act quickly when the legislative window opens. A failure to do so quickly will enable the trial lawyers to mobilize their opposition and forestall any legislative relief until the possibility of passage has passed.

Most Common Causes of Claims in the AICPA Plan 1990



1. Tax Engagements
Claims arising from late filing of returns and from underpayment of estimated tax because of alleged negligence of the accountant, which results in penalties, interest and other serious harm to the client. Some claims also arise because of the disallowance of the treatment of items reported on the tax return prepared by the accountant.

2. Audit Engagements
Claims alleging that a CPA firm did not properly discharge its obligations in an engagement to examine books and records of a company in accordance with Generally Accepted Auditing Standards (GAAS) and to report on whether the financial statements are presented in conformity with Generally Accepted Accounting Principles (GAAP).

3. Accounting Services
Claims alleging improper execution of an engagement to provide accounting services (referred to as "write-up," "unaudited financial statement work," or "compilation and review") and although no opinion was expressed, assurance was given that nothing came to the accountant's attention during the limited review to indicate that Generally Accepted Accounting Principles (GAAP) were not being followed.

4. Fiduciary
Involves an accounting engagement in which the accountant handles money or property for the benefit of their client.

5. Business and Investment Advice
Involves audit or accounting services as well as tax and MAS (Management Advisory Services) advice. This category is basically comprised of claims relating to business acquisition evaluations and projections and such things as advising on a suitable mix (equity vs. debt) of portfolio investments for business and funds. Not included are financial management or handling of funds which are primarily fiduciary responsibilities.

6. Management Advisory Services
Claims alleging that advice given by an accountant to a business in order to improve its efficiency and/or make maximum use of its resources was incorrect.

A Hidden Danger of Financial Institution Audits

By Richard L. Junkermann
Stogniew & Associates
St. Petersburg, Florida

The past few years have seen an unprecedented number of professional malpractice claims involving CPA firms which audited financial institutions that subsequently failed. Claims have been made primarily by regulators or former shareholders in an attempt to recover losses of the deposit insurance fund or their investment, respectively. In some cases, the claims have been complicated by the fact that partners and/or professional staff of the CPA firm had loans from the financial institution, thereby prompting allegations of conflicts of interest. Regardless of the merits of the claim with respect to professional competency issues, the CPA's loans from the financial institution provides the claimant's attorneys with a basis to challenge the CPA's motivations and integrity.

In response to the dramatic increase in such claims, the AICPA's Professional Ethics Executive Committee amended the rules regarding loans to auditors of financial institutions at its September 1991 meeting. According to *The CPA Letter* of October 1991, beginning on January 1, 1992, "...auditors will be permitted to obtain only automobile loans or leases, credit-card and cash-advance balances that do not exceed $5,000 in the aggregate, loans on the cash surrender value of insurance policies and loans collateralized by cash deposits..." from financial institutions that are audit clients. However, the amended rules permit all existing loans to be "grandfathered" as long as such loans are kept current, are not renegotiated and, if applicable, remain adequately secured.

While the revised rules should substantially reduce the potential for conflicts of interest allegations to complicate professional malpractice claims with respect to loans obtained in the future, existing "grandfathered" loans should be closely reviewed and evaluated to assure that such loans, at a minimum, comply with the spirit of the revised rules. As risk management consultants to approximately 2,000 financial institutions, attorneys, and CPAs, we have seen many lending relationships between CPAs and their financial institution audit clients which were entered into on an objective, arms-length basis at the time the loans were made, but became subject to "second guessing" when the institution's financial condition subsequently deteriorated. Additionally, the CPA should evaluate the potential for conflicts of interest allegations if there are any financial relationships with directors and officers of the financial institution. Although such financial relationships may be totally independent of any involvement with the financial institution, the relationship nevertheless could provide the claimant's attorneys with ammunition to complicate or inflame the primary claim of professional malpractice.

The financial turmoil of the 1980s largely created the explosion of malpractice claims and litigation of the past few years. The 1990s will continue to be a turbulent time for virtually all facets of the economy and CPAs will no doubt continue to be a target for regulators, investors, and others who seek to recoup losses. Therefore, individual CPAs and firms must take all steps possible to minimize their exposure to claims of professional malpractice and allegations of conflicts of interest. While some of these steps would appear to be extreme in comparison to standards of prior decades, CPAs must now evaluate potential exposures under all possible scenarios and circumstances.

Mr. Junkermann is a CPA who worked in public accounting, thrift and banking industries before joining Stogniew & Associates in 1985. He is Director of Consulting Services for the firm, which has conducted approximately 2,000 risk management surveys and internal control evaluations of financial services businesses in the United States and internationally.

Choosing Your Limit of Liability, Beware of Claim Expenses

By Michael J. Chovancak
Assistant Vice President
RBH Direct Group

There are a number of factors that should be considered when choosing the appropriate limit of liability for your accountants professional liability insurance policy. Among them are:

1. Know your client base and anticipate the largest exposure (claim) your firm could experience from your largest client.
2. Legal climate in your particular state (size of awards/ settlements).
3. Industries served by your clients — financial institutions or SEC, for example, have a tendency to produce not only a frequency of claims, but a severity problem (higher dollar amount of suits).
4. Types of engagements — audits, for example, may involve third-party suits and thus present a potential greater loss severity than a tax engagement.

However, one should not forget a very important factor when considering limits of liability, and that is **claim expenses.**

Claim expenses encompass all the surrounding expenses incurred in a suit except for the actual damages involved. That is to say, the attorney's fees, expert witness fees, research fees, adjuster's fees, etc. Insurance company claims personnel expenses (salaries) are *not* included. Claims expenses, as defined herein, have historically ranged from 40-50% of the total claim payments under the AICPA Plan!

Suits against accountants are very difficult and expensive to defend. Because the court and jury are often unfamiliar with the terms or procedures used in the accounting profession, the defense often needs to devote a good deal of its time and money educating the court to adequately defend the accountant. Often to do so, an accountant (or expert witness) is hired specifically to not only review the workpapers of the accused accountant, but also to offer testimony in court to normal accounting procedures, controls, documentation; or better put "This is how standard accounting procedures are practiced and this is where Mr. X either followed generally accepted procedures or..."

The expenses incurred to conduct this defense are included in your limit of liability![1] To put numbers to this revelation, let us assume that an accountant has a policy with a $1,000,000 limit of liability and that a suit for actual damages has been filed against the accountant for $2,000,000 with the cost to defend totaling an additional $250,000. (For simplicity, the example is without a deductible). If the court rules against the accountant, the amount of liability insurance remaining, to satisfy the $2,000,000 judgment after paying the $250,000 in defense expenses is $750,000. The accountant then would be responsible for the remaining $1,250,000 from his personal assets.[2]

The numbers used in this example are for illustrative purposes only, but you can plainly see that accountants' suits are expensive to defend and can seriously erode the limit of liability remaining to pay the actual claim damages. Please keep this in mind when determining the adequacy of the limit of liability for your particular firm.

---

[1] Some states require policies to pay expenses outside the limit of liability. In these states, rates are adjusted accordingly to accommodate the additional exposure to the insurance company.

[2] Please remember that the limit of liability in effect at the time the *claim is made,* rather than the limit of liability in effect when the *engagement was performed/completed,* is the limit of liability that will be used for the claim. The importance of this fact is that many claims are made 2-3 years after the completion of an engagement. Thus, if you choose to reduce your limit of liability on a subsequent policy, the claim would be processed at the lower limit of liability in place at the time of the claim notification.

Before Dividing Your Practice or "Demerging" Explore Your Liability Insurance Options

By Michael J. Chovancak
Assistant Vice President
RBH Direct Group

The author has received a number of telephone calls from firms that recently experienced a division of their practice ("demerged") inquiring about how their liability insurance coverage will continue to protect them on a going forward basis as well as for prior acts exposures. The AICPA Plan has two methods to handle divisions:

1. One firm maintains the existing policy and prior acts coverage while the other firm purchases a new policy without prior acts (including the

continued on page 8

Underwriter's Corner

The Underwriter's Corner was developed as a service to provide AICPA Plan insureds with answers to frequently asked questions. Should you have any questions which you would like answered in the publication, please address your questions to:

Michael J. Chovancak, Editor
AICPA Newsletter
c/o RBH Direct Group
4870 Street Road
Trevose, PA 19049

*I've read with interest your advertisements and promotional literature advising me of a 20% rate reduction in 1991. I recently received my 1991 renewal quotation and do **not** see a 20% reduction. Please advise how my premium is calculated and where the 20% went?*

The AICPA Plan, through the input of member firms, actuaries, and industry sources determined that a "billing based" premium calculation was more equitable and representative of the risk inherent to the insurance carrier than the "head count" basis used by other insurance carriers.

In 1991 the base rate factor (the factor used to multiply by the firm's total billings to arrive at the base premium for the lowest limit of liability) was reduced 20% — from .015 to .012. In our reader's particular case, billings grew approximately 13% from 1990 to 1991, thus diluting the 20% reduction as it translates to actual premium — however, the premium as a percentage of billings eclipsed the 20% reduction.

Therefore, although the *rate* has been reduced 20% in 1991, the actual final *premium* can be impacted by the volume of billings (as in our example). Other factors that can impact the premium from year-to-year include: loss experience, areas of practice, significant changes in the practice and the location of the practice.

Rating Information

	1991	*1990*	*Percent Change*
Billings	$402,294	$356,012	+13%
Staff	6	6	-
Limit/Deductible	$500,000/$5,000	$500,000/$5,000	-
Total Premium	$6,532	$7,417	-12%
Premium as a % of billings	.016	.021	-24%

appropriate prior acts discount) at a significantly lower premium. This option is normally used when there exists a clear majority survivor (as measured by billings maintained by the surviving firm) who maintains the policy and the prior acts and a clear minority survivor who gets the benefit of the lower premium and no prior acts coverage. With this option, the smaller firm's prior acts would be covered under the larger firm's policy.

2. The original policy is cancelled and rewritten with both firms receiving new policies and both firms maintaining prior acts coverage. To prevent potential overlapping of coverage and stacking of limits if a suit was filed for acts during these prior periods, each policy would be written with an endorsement excluding the work of the other.

This option is normally used when the division is fairly equal as to the billings on a going forward basis.

The reason we strongly recommend that firms call us to discuss the various options, *prior to* divisions is two-fold:

Dividing Your Practice

continued from page 7

1. It assists the firm in structuring the dissolution contract to address not only the asset/liability distribution, but also the liability insurance policy and the extremely important prior acts issues.

2. In the "less-than-friendly" divisions, it allows us to advise how both firms can maintain their prior acts and avoid difficulties later when one firm realizes that it does not have prior acts on its policy and is "at the mercy" of the other firm to maintain coverage and thus maintain prior acts.

The message here is, simply, consider your liability insurance in your division discussions and agreements *prior* to formalizing the division contract and contact your respective RBH Direct Group Account Representative, or quite simply "talk to us first."

SEASON'S GREETINGS

AICPA Professional Liability Insurance Plan Committee

AICPA Professional Liability Insurance Plan Committee
c/o Newsletter Editor
Rollins Burdick Hunter
4870 Street Road
Trevose, PA 19049

BULK RATE
U.S. POSTAGE
PAID
BELLEVUE, WA
PERMIT
NO. 316