



California Legislature

Joint Legislative Audit Committee

GOVERNMENT CODE SECTION 10500 et al

CHAIRMAN
RICHARD ROBINSON
ASSEMBLYMAN

VICE CHAIRMAN
ALBERT RODDA
SENATOR

□

925 L STREET
SUITE 750
SACRAMENTO 95814
(916) 445-0255

Office of the Auditor General

June 13, 1979

Letter Report 916

Honorable Richard Robinson
Chairman, and Members of the
Joint Legislative Audit Committee
State Capitol, Room 4158
Sacramento, California 95814

Dear Mr. Chairman and Members:

In response to a Resolution of the Joint Legislative Audit Committee, we have conducted a review of certain aspects of the Cooperative of American Physicians, Inc. (CAP) and the Mutual Protection Trust (MPT). CAP is a professional organization which was incorporated in November of 1975 to serve the general and professional interests of California physicians and surgeons. CAP sponsored the formation of MPT, an interindemnity trust which provides mutual malpractice protection for California physicians and surgeons.

SUMMARY

This study highlights these points:

1. The financial audit reports of CAP and MPT by Price Waterhouse and Co. for the year ended December 31, 1978 met generally accepted auditing standards.
2. The MPT Fund Corpus which is composed of the Initial Contributions of all MPT members is intact and has not been used for unauthorized purposes.
3. An actuarial study of the MPT income and corpus conducted by the Wyatt Company of Chicago, Illinois in March of 1979 concludes that increasingly larger assessments will be required of MPT members to ensure trust viability; however, assessments have not yet been made. Complete information has not yet been distributed to the entire membership. Further, there is no legal requirement that sufficient reserves be maintained

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 2

to meet projected obligations. We recommend that complete actuarial studies of this type be regularly conducted and distributed to all trust members.

We also reviewed significant issues raised in a CAP shareholder derivative action which alleges certain improprieties against the organization. We concluded that (1) significant weaknesses exist in CAP's internal accounting controls and related accounting procedures; (2) the Board of Directors has not exercised its responsibility to appoint, fix compensation, prescribe duties and set policies; and (3) the Board of Directors has not established policies concerning conflict of interest.

INTRODUCTION

In 1975, the cost of medical malpractice insurance had escalated and its availability had shrunk. In response to this situation, California physicians formed the Cooperative of American Physicians, Inc. (CAP). CAP's goal was to offer California physicians a nonprofit alternative to conventional medical malpractice insurance through the formation of an interindemnity trust.

Implementing Legislation

The concept of an interindemnity trust for physicians was contained in AB 1898 (Chel), a bill supported by CAP. AB 1898 (Chapter 1462, Statutes of 1976) exempted unincorporated interindemnity trusts from specified corporate security laws and added Section 1280.7 to the Insurance Code. Section 1280.7 as amended contains the following major provisions:

- The trust is administered by a board of trustees, all of whom are physicians;
- Members of the trust are initially and periodically screened by a peer review committee;
- Members who fail to either pay an assessment or comply with any provisions of the trust agreement may be terminated from the program. The act authorizes hearing procedures for these members;
- The trust corpus (or Initial Contributions) must contain at least \$10 million. The average initial contribution must be at least \$20,000;
- All trust funds are deposited in banks and savings and loan associations designated by the board. Funds in excess of current needs are invested in specified areas;

- The income earned on the corpus of the trust fund is the source for the payment of the claims, costs, judgments, settlements and costs of administration. If income is insufficient to pay such costs, the board has the authority to assess participating members for all amounts necessary to meet the obligations of the agreement between the trust and its members;
- If a member dies, the Initial Contribution is returned to the decedent's estate and that estate continues to be covered for any claims arising from the period of membership. Members who retire from practice after reaching age 65 are similarly covered except that their contribution is returned ten years following retirement. In either case, neither the decedent's estate nor the retiree may be additionally assessed;
- Annual financial statements must be furnished to each member of the trust;
- The law prohibits a series of specified unfair and deceptive practices in connection with the operation of the trust;
- Coverage is \$1 million for each act of malpractice which occurs while the physician is a member of the trust.

Mutual Protection Trust (MPT)

Following the enactment of AB 1898, CAP created the Mutual Protection Trust. Only CAP members in good standing may apply for membership in MPT. As of December 31, 1978, the MPT membership was nearly 1,400. MPT is governed by a Board of Trustees, all of whom are physicians. The trust fund corpus contained over \$30 million as of December 31, 1978.*

MPT is structured to provide an occurrence type of coverage, a form of insurance in which all acts (or omissions) within the policy period are covered, regardless of when a claim is made. Claims-made coverage, another form of medical malpractice insurance, covers incidents occurring within the policy period provided that the claim is made while the policy is in effect.

* A description of the financial condition of MPT is contained in the Mutual Protection Trust Report and Financial Statements December 31, 1978 and 1977.

Current Relationship
Between CAP and MPT

In 1977 MPT and CAP entered into a management agreement which delegated to CAP certain administrative functions required by MPT. For example, CAP collects annual MPT dues of \$500 required in the trust agreement between MPT and the members. The management agreement also entitles CAP to reimbursement for services it provides.

Therefore, although MPT functions as a separate legal entity, it is contractually linked to CAP and dependent upon that organization for certain administrative services.

Audit Scope and Methodology

This report covers three areas:

- Review of the financial audits of CAP and MPT by Price Waterhouse and Co. for the year ended December 31, 1978
- Review of the actuarial study of MPT
- Review of significant issues raised in the derivative action or related to the above reviews.

We gathered information through interviews and site visits and reviewed data supplied to us by the California Medical Association, CAP, MPT, plaintiffs in the derivative action, Price Waterhouse and Co., State Department of Corporations and the State Department of Insurance. Our review included limited independent testing of accounting records and financial statements for CAP and MPT. In addition, we tested the audit work of Price Waterhouse and Co.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 6

REVIEW RESULTS

REVIEW OF PRICE WATERHOUSE AND CO. AUDITS

As part of our work, we reviewed the audit methodology and audit work performed on both MPT and CAP for the year ended December 31, 1978 by Price Waterhouse and Co. This work included a quality control review of the test of sufficiency of the auditor's reports, the financial statements and the supporting workpapers. In addition, we tested a limited number of accounting transactions at CAP and MPT. We also reviewed the internal control work Price Waterhouse and Co. performed, including their reliance on the existing controls in the performance of their substantive tests of account balances.

CONCLUSION

Based on the results of this review, we found no evidence to indicate any deviation by Price Waterhouse and Co. from generally accepted auditing standards as defined by the American Institute of Certified Public Accountants.

ACTUARIAL STUDY OF MPT

In March 1979, the Wyatt Company of Chicago, Illinois issued an actuarial study of the MPT. The Wyatt Company is an independent company which contracts to perform actuarial evaluations along with other related services to insurance companies, accounting firms, law firms and employee organizations.

The study had the following objectives:

- Evaluate the liability for claims, both known and unknown, incurred up to December 31, 1978
- Estimate the future loss expectancy of MPT
- Recommend any changes in coverage to continue the viability of the MPT program
- Project assessment amounts and their approximate timing for future years.

Blending the past experience of MPT members and more than 9,000 paid claims countrywide, the company arrived at four conclusions and recommendations.

First, MPT has incurred \$7,888,000 in liability claims as of December 31, 1978, including \$1,968,817 reserved for known losses.

Second, based on a constant membership of 1,500, the actuary projected for the years 1979 to 1982, (1) the expected number of claims, (2) total amount of loss and (3) average loss per member for MPT. The following table illustrates those projections:

ACTUARIAL PROJECTIONS

<u>Injury Year</u>	<u>Number of Claims</u>	<u>Amount of Loss</u>	<u>Amount Per Member</u>
1979	369	\$ 9,802,000	\$ 6,535
1980	387	11,537,000	7,691
1981	406	13,580,000	9,053
1982	426	15,984,000	10,656

Third, the study recommended a change in coverage provisions regarding terminations. Specifically, members who terminate by transfer should be assessed for tail coverage (tail coverage refers to coverage against claims arising after the policy has expired).

Finally, the study concludes that in addition to accumulated trust fund income, members will need to be assessed to provide the necessary revenue to cover claims. If assessments were initiated in 1979 based upon expected losses, they would approximate the following pattern:

REQUIRED ASSESSMENTS PER MEMBER
BY CLASS OF RISK AND YEAR

<u>Year</u>	<u>Low Risk</u>	<u>Medium Risk</u>	<u>High Risk</u>
1979	\$2,533	\$2,895	\$3,256
1980	3,214	3,673	4,132
1981	4,015	4,589	5,162
1982	4,959	5,668	6,375

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 9

According to the above Wyatt study table, membership assessments will nearly double between 1979 and 1982 to cover losses which the income generated by the trust cannot. In fact, the study states that "assessments of significant magnitude will be required of MPT members in order to maintain the financial strength of the program and to distribute equitably the cost of members' claims."

The Wyatt study recommends that MPT adopt an ongoing program of assessments. The need for implementing this recommendation is stated in the study:

In summary, we wish to underscore our recommendation for an on-going program of assessments that will approximate the cost of coverage not provided from investment income. This is essential in spite of the apparent surfeit of cash in the MPT. We believe it is important that the doctors exposed to loss in each year should pay their just share. Waiting to assess members until the cash needs of the fund are critical will not serve to provide this matching of revenue to exposure. Some compromise should, therefore, be worked out with MPT members so that assessments need not await the need for cash.

Therefore, the Wyatt Company concludes that income from the corpus trust fund must be augmented by assessments during the active membership of the doctor. Insurance companies are required by the Insurance Commissioner to "maintain reserves in an amount estimated in the aggregate to provide for the payment of all losses and claims for which such insured may be liable..."; however, MPT is exempted from this provision of the insurance codes.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 10

Status of the Wyatt
Study Recommendations

According to the cover letter accompanying the year-end audited financial statements for 1977 and 1978, an assessment is not contemplated at this time. CAP management states that it will not implement the recommendation to levy assessments because, according to Article VII, Section 3, of the trust agreement, the Board of Trustees can only levy assessments if the trust will run short on income within the next 12 months. If the board cannot in good faith predict this situation, it cannot assess the membership.

However, Article VII, Section 2, implies that the board has nearly unlimited authority to levy assessments:

Each MPT Member shall be obligated to, and shall, pay to MPT amounts as hereinafter provided, which amounts are herein called "Assessments." Subject to the provisions hereof, the Board of Trustees shall have the power and authority to determine all matters in connection with Assessments, including, without limitation, power and authority to determine where, when and how Assessments should be paid to MPT, and each MPT Member shall comply with all such determinations.

CONCLUSION

The trust agreement provisions relating to the ability of the Board of Trustees to levy assessments are unclear.

RECOMMENDATION

We recommend that the Legislature consider amending Section 1280.7 to clearly state whether the trustees of a trust formed pursuant to that section should have limited ability to levy assessments.

Distribution of Wyatt Study

The actuary's finding that MPT has incurred \$7,888,000 in liability claims has been communicated to the MPT members in the report and financial statements for 1978 and in an MPT quarterly report. However, the recommendations regarding an ongoing program of assessments, future losses expected, and revising tail coverage provisions were not included in the information sent to the membership.

CONCLUSION

Because there is no assurance that the members of MPT are completely informed regarding the future financial requirements of the trust, it is our opinion that the members of MPT need actuarial reports to fully understand the financial status of the program.

RECOMMENDATION

We recommend that the Legislature consider amending Section 1280.7 of the Insurance Code to require that actuarial studies of trust funds forming under the section be periodically performed and that the full text of such studies be distributed to the entire MPT membership.

Analysis of Premium Savings
Provided by CAP

CAP management gave us analysis workpapers computing premium savings to MPT members for both occurrence and claims-made insurance companies. We have the following concerns about this analysis:

- Individual premium rates are subject to surcharge and other variations in individual cases to reflect the claims history or practice standard of the physician. These variations were not reflected in the analysis;
- Variations in premium rates occur within each specialty; nevertheless, the analysis used a single rate for each specialty;

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 12

- Although there are stock, reciprocal and mutual insurance companies, the analysis only included stock companies;
- Coverage variances between MPT and the insurance companies were not reflected in the analysis;
- A seven percent rate of return on the physician's initial contribution was used although the long-term annual yield was over 8.7 percent.

CONCLUSION

Because of these omissions we are unable to rely on the study in its present form.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 13

REVIEW OF SIGNIFICANT ISSUES

A shareholder derivative action was filed on April 5, 1979. The action alleged improprieties, misuse of funds and invasion of the trust by CAP board members and employees. In connection with these allegations, we have included the following in our review of CAP and MPT:

- Weaknesses in management controls
- Review of compensation received by executive officers
- Examination of an alleged invasion of the MPT corpus
- Potential conflicts of interest.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 14

WEAKNESSES IN MANAGEMENT CONTROLS

The derivative action complaint filed April 5, 1979 alleges that officers of CAP committed certain improprieties, including (1) making payments for the benefit of individuals without prior approval from the Board of Directors, (2) payments by CAP for the benefit of business entities in which the president of CAP has a financial interest, (3) using corporate control and office for personal gain and (4) invading the trust corpus. Each of these allegations indicates that the existing management controls may be ineffective.

Because of the foregoing circumstances, we reviewed Price Waterhouse and Co.'s audit workpapers of its examination of the financial statements of CAP for the 7 months ended December 31, 1977, and those of CAP and MPT for the year ended December 31, 1978; reviewed the management letter to the president of CAP which Price Waterhouse and Co. issued as part of its examination of the financial statements of CAP for the years ended May 31, 1976 and 1977; interviewed several former and present employees; and independently conducted limited tests of accounting activities.

Described below are some of the management control weaknesses identified by Price Waterhouse and Co. To the best of our knowledge, all weaknesses described are still present although Price Waterhouse and Co. reported some of the weaknesses to CAP as early as January 9, 1978, in a management letter.

Included in the January 9, 1978 management letter were the following recommendations for improving internal accounting controls and related accounting procedures.

- The Company should consider formulating and publishing a policy with respect to ethics in conducting the business of the Company.

...A carefully prepared statement of policy and guidelines in areas involving ethical considerations could help avoid inadvertent or ill-considered actions contrary to the ethical standards of the Company.

- There should be established a formal policy regarding conflict of interests.

Adopting and publishing a definite policy regarding conflicts of interests would remind officers and employees of their responsibilities to the Company in their dealings with outside parties.

- An accounting-operating manual should be prepared which outlines policies, practices, procedures and guidelines.

Preparation of such a manual would provide additional assurance of consistency in accounting policies, practices and procedures, serve to define job responsibilities for key employees and aid in the training of employees.

- Reimbursements of employees' travel, entertainment and other expenses should be properly documented.

In order to provide adequate documentation of cash disbursements and to avoid possible disallowance of deductible expenses by the Internal Revenue Service, employees' travel, entertainment and other expenses should be documented in accordance with the guidelines established by the Service. Both the Company and its employees may be assessed additional taxes if such disbursements are not properly documented.

The Price Waterhouse and Co. workpapers included several comments regarding weaknesses and recommendations in internal control as part of its examination of the financial statements of CAP for the year ended December 31, 1978 and the seven months ended December 31, 1977. Following are three sections extracted from the workpapers.

- Present Procedures and Weakness Noted

The client does not disseminate corporate ethics and conflicts of interest policies to officers, employees, vendors or customers, nor does the client monitor compliance of such policies or

summarize transactions with related parties. This procedure could result in violation of conflicts of interest policies due to a lack of knowledge of them. It could also result in unauthorized transactions by or for related parties going undetected due to a lack of a summary of related party transactions.

Recommendation

The client should formalize, record and disseminate corporate ethics and conflict of interest policies. Client should also summarize related party transactions.

- Present Procedure and Weakness Noted

The executives currently authorized as signators on the various bank accounts have not been formally authorized by the Board of Directors. In addition, it has come to our attention that none of the officers of CAP other than the president have been formally approved by the Board of Directors.

Recommendation

Procedures should be implemented to require Board of Director approval for all changes to the listing of those authorized to sign on the various bank accounts and all officers of the company and their salaries.

- Present Procedure and Weakness Noted

The trust corpus and trust income accounts are maintained by the three banks. The only control over the types of securities the banks may invest in is AB 1898. Additionally, MPT management has requested that securities be evenly distributed between short, medium and long term maturities. No one at MPT monitors the types of investments made by the banks or maintains an independent record of the securities owned by MPT.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 17

Recommendation

The client should designate several members of the Board of Trustees as an investments committee to monitor the investment activities of the trust custodians. In addition, the client should maintain a record of the securities owned by MPT and reconcile the monthly trust statements received from the banks to their records. Records should also be kept of interest income received and gains and losses on sales of securities to provide an independent control over bank record keeping procedures.

To reasonably safeguard assets against loss from unauthorized use or disposition and provide reliable financial records for preparing financial statements and maintaining accountability for assets, we suggest that management adopt the recommendations set forth above.

COMPENSATION OF EXECUTIVE OFFICERS

The derivative action states that (1) officers of CAP were compensated without verification of time spent on CAP or MPT matters, (2) that officers of CAP charged and caused CAP to pay personal expenses and that (3) without accounting for time or expense to the members of the board, the President of CAP received compensation for services rendered in connection with the formation of CAP during the period from August 1975 to August 1978.

Executives of CAP receive a salary, reimbursement for business expenses and, in most cases, a monthly automobile allowance. Following is a schedule of the monthly salaries and automobile allowances for each CAP executive as of May 31, 1979:

<u>Employee</u>	<u>Title</u>	<u>Salary</u>	<u>Auto</u>
Sabri El Farra, M.D.	President	\$10,000	\$250
Robert Evans, Ph.D.	Executive Vice President	5,417	250
E. King Hempel	Vice President--Public Relations	3,167	250
Carroll Wilson	Vice President--CAP Services, Inc.	1,458*	--
Daniel Tosney	Vice President--Claims	2,917	250
Carol Durbin	Vice President--Program Coordination	2,500	--
Karen Olsen	MPT Membership Admin.	1,833	250

* C. Wilson worked full-time for CAP at a monthly salary of \$2,917 until April 30, 1979. As of May 1, he is working half-time at the indicated salary.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 19

In addition, some employees of CAP have been issued VISA credit cards for business use. Credit limits from \$500 to \$3,000 were confirmed by a letter from the CAP Vice President-Finance to the Bank of America on November 13, 1978. Our review of the VISA billings disclosed charges made for gasoline, car washes and expenses, staff luncheons, staff dinners, travel and lodging, business luncheons and conferences and numerous billings marked "no explanation."

The by-laws of CAP define the power and duties of the Board of Directors relative to employees of the corporation in Section 4.01(d), "to bind and remove at pleasure all officers, agents and employees of the corporation, prescribe their duties, fix their compensation, and require from them security for faithful service." However, after reviewing all of the CAP Board of Directors' minutes for 1976 through April 1979, we did not find any approval of title, rate of compensation or appointments of any CAP employees with the exception of the president.

The policy for the president's compensation is stated in the CAP Board of Directors' minutes for August 30, 1978.

It was agreed that Dr. El Farra be compensated for his services as President and Board Chairman for the calendar period between April 20, 1978 and the next Annual Meeting in April of 1979, by a Letter of Intent between Dr. El Farra and the CAP Board of Directors which would include fee for service compensation at a rate of \$75.00 per hour with a minimum of four (4) hours per day, and a maximum of eight (8) hours per day, an agreed vacation time payment, and an agreed expense account.

We did not obtain documentation of the hours worked between September 1, 1978 and April 30, 1979. The president stated he has been compensated at a uniform rate of \$10,000 per month since July 1977.

Also, in 1978 the president received compensation for services rendered from 1975 through 1977 in connection with the formation of CAP. The CAP Board of Directors' minutes for August 30, 1978 states this retroactive compensation policy:

1. Dr. El Farra's expenses were reviewed, and it was agreed that his expenses of \$50,000 for the past three (3) years would be payable in one lump sum up to April 20, 1978.
2. A review of Dr. El Farra's hours of service was made, and it was agreed that he be paid from August 1975 to June 1977 at a rate of \$75.00 per hour. His services from June 1977 to April 20, 1978 would be paid at the previously accepted rate of \$50.00 per hour.

To support the 1978 payments made to the president for past services, the board used a schedule entitled "Personal Time and Expenses Regarding the Formation and Administration of the Cooperative of American Physicians, Inc." No other documentation was provided in support of these hours and expenses. The following is a summary of those expenses:

Compensation for Hours		
of Service (4620 hours x \$75)	\$346,500	
(1584 hours x \$50)	<u>79,200</u>	\$425,700
Auto Allowance	16,700	
Gas and Oil	11,100	
Normal Expenses	<u>18,500</u>	<u>46,350</u>
Total Compensation		\$472,050

Deducted from this amount of total compensation are payments for compensation and expenses totaling \$153,993 which the president received prior to August 31, 1978; these payments reduced the amount actually owed the president to \$318,057. To fully repay the president's services, the following payment schedule was established:

Payment immediately	\$ 46,350.00
23 Payments @ \$11,321.13	260,385.99
One Payment @ \$11,321.01	<u>11,321.01</u>
	\$318,057.00

Between September 1, 1978 and December 31, 1978, the following payments for past services were made to the CAP president:

Expenses	\$ 46,350.00
Compensation for Hours of Service (\$11,321.13 x 6 payments)	<u>67,926.78*</u>
	\$114,276.78

The remaining \$203,780.22 (\$318,057.00 less \$114,276.78) was not recorded as a liability in the CAP December 31, 1978 financial statements because the president of CAP has confirmed by letter that he will not claim any additional expenses or remuneration relating to past services.

The CAP Board of Directors in their meeting on March 22, 1979, retroactively approved payments made to the president during 1978. However, the amount stated differs from the actual payments made:

<u>Payment</u>	<u>Actual Payments Through 12/31/78</u>	<u>Approved by BOD 3/22/79</u>
Out of pocket expenses	\$46,350	\$46,300
Organization services to CAP/MPT	82,927	56,000

The Board of Directors resolved "that this Board of Directors hereby ratifies, confirms and approves the payments made by this corporation to Dr. S.M. El Farra during 1978."

CONCLUSION

Policies concerning personnel structure, appointments, compensation, credit cards, auto allowances and expense reimbursements have not been formally established to date. The CAP Board of Directors has not exercised its power and duties to appoint, fix compensation, prescribe duties and set hours of required service for executives of CAP.

RECOMMENDATION

The Board of Directors of CAP and the Board of Trustees of MPT should formulate a policy and prepare guidelines for all executive compensation and benefits including salary and allowances for travel, entertainment, automobile, insurance and verification of time in CAP/MPT service.

* This amount does not include an additional \$15,000 received by the president prior to September 1, 1978 for CAP/MPT organizational services.

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 23

CONCLUSION

In our opinion, the MPT Fund Corpus was not invaded for unauthorized purposes.

INVASION OF THE MUTUAL
PROTECTION TRUST FUND CORPUS

Plaintiffs in a shareholder derivative lawsuit alleged that the Mutual Protection Trust Agreement was violated by an invasion of the MPT Fund Corpus. This alleged invasion resulted because funds from the MPT Fund Corpus were transferred to CAP for administrative expenses via the MPT Fund Income.

The Mutual Protection Trust Agreement, Article III, Section 4, permits the Board of Trustees to use funds of the MPT Fund Corpus for the following purposes:

1. Investment of the MPT Fund Corpus
2. Return of the Initial Contribution due to death or retirement of a member
3. Return of Initial Contribution on the termination of MPT membership
4. Payment of claims not exceeding ten percent of the MPT Fund Corpus, with such amounts being promptly repaid to the Fund Corpus by levying an assessment against MPT members
5. Dissolution of MPT.

The MPT Fund Corpus may not be used for any other purpose unless authorized at any meeting by the affirmative vote of at least three-fourths of the MPT membership eligible to vote present in person or by proxy and by the written authorization of at least three-fourths of the members of the Board of Trustees.

In January and August 1978, MPT returned \$110,000 of the Initial Contribution of deceased members to either the members' estate or persons previously specified by the deceased members. According to the Mutual Protection Trust Agreement, these returns of the Initial Contribution should have been paid from the MPT Fund Corpus, not from MPT Fund Income. In December 1978, the MPT Fund Corpus reimbursed the MPT Fund Income \$110,000 for the return of the Initial Contributions.

POTENTIAL CONFLICTS OF INTEREST

The shareholder derivative action alleged that CAP made payments to benefit business entities in which the president and other employees of CAP had a financial interest. The action also cited that other dealings were for the benefit of business entities in which the president of CAP has a financial interest. We reviewed the minutes of the Board of Directors from inception to April 19, 1979 and were unable to find any policies regarding conflict of interest for employees. In addition, we reviewed the General Personnel Guidelines which contain policies regarding overtime, vacation, holidays, personal time off, etc., and we were not able to find any policies regarding conflict of interests in this manual. Due to the lack of policy, we reviewed transactions with Tri-State Leasing, Inc., Superior National Life Insurance Company and selected Safa entities in which executives of CAP have an ownership interest.

Tri-State Leasing, Inc.

Tri-State Leasing, Inc., is a leasing company formed in March 1978 primarily for the purpose of leasing automobiles to CAP members. The derivative action asserts that (1) the president did not disclose his ownership interest in Tri-State and (2) that the president of CAP decided to cut his losses in Tri-State by selling Tri-State to CAP.

Holders of Tri-State stock included the CAP president and his family (62.5 percent) and officers and former officers of CAP (6.25 percent).

On December 4, 1978, CAP Services, Inc. (CSI) was incorporated. CAP was the sole holder of all issued stock and invested \$100,000 in CSI. Then on January 2, 1979, CSI purchased Tri-State's assets and liabilities for \$61,000.

According to the notes of the 1978 CAP financial statements the pre-audit financial condition of Tri-State shows a net loss of \$71,000 for the nine months ended December 31, 1978. Because of the controversy involving CSI's purchase of Tri-State, the stockholders of Tri-State returned the \$61,000 to CSI on January 22, 1979.

According to notes to the 1978 CAP financial statements, CSI has continued to operate Tri-State Leasing, Inc. since January 2, 1979. According to the current CAP controller, CAP currently pays an employee \$1,275 per month whose sole duty is the administration of CSI. Because the stockholders of Tri-State have returned the \$61,000 to CSI, it is unclear who presently owns the Tri-State assets and who is responsible for the liabilities.

Superior National
Insurance Company

The derivative action states that Superior National Insurance Company (Superior) was organized at CAP expense to benefit the president of CAP or entities controlled by him through the sale of casualty insurance to CAP members and the president of CAP induced CAP to pay salaries, expenses, auto lease payments, legal fees and California franchise taxes.

Superior was originally founded by Lawrence Reid, Vice-President--Finance of CAP (former employee). CAP made payments which enabled Superior to research the formation of a liability insurance company. For instance, CAP paid franchise tax, actuarial, and corporate filing fees on behalf of Superior.

On February 22, 1979, Superior reimbursed CAP \$27,015 as a final settlement of organizational expenses.

Safa Entities

The derivative action states that (1) the president had CAP make payments to Safa entities without authorization by or disclosure to the CAP board of directors and (2) these payments were made for the benefit of the president.

The president of CAP and his brother have varying ownership interests in Safa entities. These are some examples of dealings between CAP and Safa entities:

- CAP purchased furniture in the amount of \$6,233.40 on two separate occasions from Safa International. Management has stated the furniture was purchased at a discount;

Members of the
Joint Legislative Audit Committee
June 13, 1979
Page 26

- The CAP offices have been located in Safa Medical Center since October 1975. Currently, annual rental is \$54,000. Management has stated the rent is comparable to rents charged in a neighboring building;
- CAP has paid Vincent Soukup, a full-time employee of Safa Investment, \$200 per month since January 1978 to provide consultation on personnel matters. Management has stated Soukup provides continuing consultation services and aided in the preparation of the personnel manual.

CONCLUSION

The potential exists for CAP employees to commit CAP to transactions providing benefits to business entities in which they have an ownership interest. The Board of Directors has not provided policies relating to either disclosure of potential conflicts of interest or transactions with organizations in which CAP employees have a financial interest.

RECOMMENDATION

We recommend that the Board of Directors of CAP and the Board of Trustees of MPT establish, publish and distribute a definite policy regarding conflicts of interest.

Respectfully submitted,



THOMAS W. HAYES
Acting Auditor General

Staff: Karl W. Dolk, CPA
Curt I. Davis, CPA
Dore C. Tanner, CPA
Richard B. Weisberg, ESQ
Geraldine Heins