

A Question of Ethics

Are CPCUs Ethically Required to Exercise Due Diligence in Professional Activities?

*"[B]ut let justice roll like water,
and uprightness like a never-failing
stream!"*

—Amos 5:24 (NJB)

A fundamental tenet within the framework of our ethical rules is the obligation to act with due diligence in our professional endeavors. The CPCU Society Creed provides in part as follows: "I will use due diligence to ascertain and understand the needs of my clients or principal and will only undertake assignments that I can perform in a proper and professional manner."

Rule R4.1 of the American Institute of CPCU's Code of Professional Ethics reflects this principle as a mandatory duty in the following terms: "A CPCU shall competently and consistently discharge his or her occupational duties." In turn, the CPCU Society's Code of Ethics, at Section 4(b)(2), supplies the following: "A member shall not fail to use due diligence to ascertain the needs of his or her client or principal and shall not undertake any assignment if it is apparent that it cannot be performed by him or her in a proper and professional manner."

What do we mean by the term "due diligence"? Why are we required to act with due diligence in our professional and business endeavors? And what can we do to institutionalize the conduct of due diligence overall?

What is Due Diligence?

The concept of due diligence seems to have arisen principally in the investment realm, but we find it ensconced in law and accounting as well. It typically refers to the process one follows in ascertaining that the material facts presented in connection with some proposed business transaction are essentially true. Thus, due diligence implies some investigative work intended to confirm the truth of what is being



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asserted and the propriety of going forward with the proposed transaction or transactions.

The financial crisis which preceded our recent presidential election, some would say, arose out of the greed of speculators who took advantage of new investment instruments laden with questionable mortgage assets in a lax regulatory environment. We read in the newspapers how different firms seemed reluctant to examine very closely the makeup of the bundled home loans that, when sold to eager investors, generated unprecedented profits and bonuses for those putting these deals together. In time, the bubble burst, erasing the paper profits and largely bringing to an end the unbridled exuberance which had suffused the marketplace.

At the heart of this financial crisis, though, is the question whether the participating investors lost sight of their obligation to exercise due diligence to ascertain that these mortgage-related investment opportunities then being presented were indeed prudent as well as profitable. In hindsight, we can see that the combined effects of an inflationary real estate market, the willingness of many consumers to extend themselves with home mortgages beyond their means, and the complicit efforts of some financiers to support these enterprises created highly adverse consequences for our nation's finances and the international banking community which participated in these

investments. Similar considerations could be said to affect the success of any proposed business transaction, most especially in the property-casualty business.

I would like to emphasize two attributes implicit in our term "due diligence." First, there is the expectation of certitude, that is, that what is being offered conforms, as much as reasonably possible, to the goods or services provided. A reasonable degree of investigative or exploratory activity presumably will help confirm the suggested equivalence. Second, there is the expectation that the efforts undertaken will be expeditious, that is, that they will be undertaken with dispatch in a workmanlike manner. Applying these concepts to traditional insurance transactions, i.e., underwriting risks, paying claims and setting aside reserves, among other things, we can posit the need to examine particular circumstances in a reasonably objective manner to ensure that whatever judgments we are called upon to discharge are fairly applied.

Why Do We Need Due Diligence?

The heart of a business relationship built on trust, as occurs with insurance dealings, is finding the person or persons with whom we deal and the particular circumstances being advanced to be trustworthy. While we can develop an implicit sense that some situations are inherently acceptable because of the sources propounding them, it

is far more reasonable to expect some degree of investigation and review before acting on them. Allowing considerations of profit or bonuses alone to cloud our judgment about the impact of these various transactions can impair the quality of the business decisions reached. They also suggest a significant conflict of interest since the private interest in question may be deemed to have superseded the fiduciary duty to the client, employer or principal.

The exercise of due diligence supplies some evidence that good judgment is being applied. That evidence could well help defuse suggestions of negligence, malpractice or other misconduct related to the judgments being exercised. In other words, taking the time and making the effort to discharge due diligence obligations can help provide a record that good faith was being exercised in the conduct of business. Ultimately, the application of due diligence, we may posit, helps us arrive at better business decisions.

What Can We Do?

Accepting the premise that our ethical values warrant the exercise of due diligence, we can start by examining our own business practices and routines. Do we approach our business challenges objectively and analyze our factual circumstances sufficiently to understand the nature of the transactions we are called upon to carry out and thereby reach reasonable results? If we harbor excessive doubts, act recklessly, or are disposed to act in a manner that only benefits us, either directly or indirectly (as might occur when we seek to benefit a friend, family member or close business associate), then we might have good reason to question the propriety of the decision or decisions being made.

We need to develop an ethical compass that appropriately guides us to make decisions in good faith

with a proper regard for the potential consequences on all concerned, but certainly with an eye to fulfilling our obligations to our clients, employers, or other principals. A significant part of that process entails due diligence in the examination of proposed transactions and the necessary follow-through to conclude them reasonably.

Appropriately, we should review Rule R4.2 of the American Institute's Code. It states, "A CPCU shall support efforts to effect such improvements in claims settlement, contract design, investment, marketing, pricing, reinsurance, safety engineering, underwriting and other insurance operations as will both inure to the benefit of the public and improve the overall efficiency with which the insurance mechanism functions."

The mandate to seek improvements in our industry should include the exploration of due diligence obligations in the context of possibly new and untried business ventures, let alone those that are recurring. Certainly, in organizational settings, it makes sense to share with colleagues and associates our thoughts and ideas about how best to carry out these ethical mandates. An outline of considerations informing due diligence as a process in generic terms may well include the following:

- Do I have the experience and expertise that will allow me to evaluate competently the transaction or transactions now pending before me?
- If I do not have the necessary experience and expertise, then will it be possible for me to develop them or otherwise act reasonably under the circumstances?
- What are the material considerations inherent in the proposed transaction? Have I identified them reasonably?
- Is there information not now known to me or other resources

that might be reasonably accessible to help with the suggested evaluation of the pending matter? May a colleague or supervisor offer valued assistance?

- If the matter is urgent, then am I reasonably equipped to act on it?
- Do I have an appreciation for the potential consequences, both intended and unintended, if my decisions are rushed or less than thorough?
- Are there newly developing trends or other unusual circumstances which may help me with the evaluation of the pending matter?
- Do my business culture, my reputation and my personal capacity for uncertainty allow me to assume the risks related to the pending matter?
- Are there any legal requirements with which I need to comply?

Developing a deliberative and analytical approach to business transactions will help to fulfill the ethical mandates discussed above. It may also engender respect among peers and colleagues for the professionalism exhibited on the job as well as prove profitable for all concerned.

Editor's note: *The opinions expressed in this column are those of the author and do not necessarily reflect the views of the CPCU Society membership, the Society's Ethics Committee, or the author's employer. In upcoming issues of CPCU News, the authorship of the "Question of Ethics" column will rotate among members of the Ethics Committee. If you have suggestions for upcoming articles or comments about the "Question of Ethics" column, please contact **Steve G. Brown, CPCU, Ethics Committee chair**, at steve.brown.bid2@statefarm.com.*