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***"WHAT DO YOU MEAN I SHOULD HAVE DISCOVERED THE
FRAUD ? ACCOUNTANT MALPRACTICE AND ITS POTENTIAL
SOURCE OF RECOVERY FOR THE FIDELITY INSURER***

PRESENTED BY:

**RUSSELL A. YAGEL
KIMBRELL & HAMANN, P.A.
SUITE 900, BRICKELL CENTRE
799 BRICKELL PLAZA
MIAMI, FLORIDA 33131
(305) 358-8181**

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I.

INTRODUCTION

A. BACKGROUND OF THE ACCOUNTING PROFESSION

A Certified Public Accountant ("CPA") is a person or firm granted a license by a State to practice Public Accounting. Before an applicant can be granted a license, most states require the applicant to meet certain educational requirements (e.g. five years of college with a minimum number of courses in accounting and business) and successfully pass the Uniform Certified Public Accountant Examination. The exam is administered by the American Institute of Certified Public Accountants ("AICPA").

The AICPA is the "self-regulator" of the accounting profession. The AICPA established a code of professional conduct for accountants and standards a CPA is required to follow in the performance of various services, such as auditing. The auditing standards are known as Generally Accepted Auditing Standards or "GAAS".

Although not all CPAs are members of the AICPA, generally, each state requires its CPA licensees to adhere to the AICPA code of professional conduct and other professional standards established by the AICPA, including GAAS. While we generally think of CPAs as "auditors", the scope of services provided by a CPA or CPA firm can be far less than an audit (i.e. compilation or review of financial statements) or may altogether be unrelated to auditing (tax services, management advisory services and financial advising services).

In recent years, CPAs have become the target of malpractice suits alleging that, during the course of providing an audit or similar type services, the CPA failed to discover a condition which, if discovered and disclosed, would have prevented some party from suffering monetary losses. This discussion will be limited to exploring the theories of recovery that can be utilized by a fidelity insurer to pursue a claim that the accountants of its insured negligently audited the insured's financial statements causing a loss to the fidelity insurer.

B. HYPOTHETICAL

ABC Insurance Company ("ABC") issued a financial institution bond to "Ted & Janes' Bank" ("T & J Bank") with the effective date of coverage being March 1, 1994. The application for the bond was submitted on February 1, 1994 and it included, pursuant to the request of ABC, a copy of the audited financial statements of T & J Bank for the period ending 12/31/93.

The CPA firm that audited T & J Bank was "Maddox, Justice & Jones, P.A.". The firm had a reputation of being major league auditors with brave hearts. Maddox, Justice & Jones had always issued "unqualified opinions" stating the audits of T & J Bank had been performed in accordance

with GAAS, and the financial statements of T & J Bank were presented in accordance with generally accepted accounting principles. Maddox, Justice & Jones has never been informed of any specific use of the financial statements, but knows that T & J Bank uses the audited financial statements in a wide variety of transactions, and the statements may be relied upon by lenders, investors, shareholders etc.

On February 26, 1995, T & J Bank placed ABC on notice of a claim involving "Deion", an officer of the bank, that had systematically embezzled \$10,000,000.00 from the bank. The illegal activity began in July of 1994 and ended with Deion's capture on the date the loss was reported.

ABC paid the \$10,000,000.00 claim of T & J Bank and began looking for sources of recovery. Deion was virtually uncollectible because, instead of purchasing a caribbean island on which to retire, he lived glamorously, spending the money as fast as he could embezzle it. During the investigation of the loss, it was discovered that a weakness in the internal control system of T & J Bank allowed Deion to embezzle the money. ABC questions whether there is any way to recover the embezzled funds from Maddox, Justice & Jones.

II. THE STANDARD OF CARE

GAAS consists of nine general standards of auditing as well as all of the Statements on Auditing Standards issued by the AICPA. Accountants will typically assert that the standard of care for accountants is determined exclusively by GAAS, and compliance with GAAS insulates the accountant from liability. Accountants are particularly fond of this argument since it allows them, in essence, to determine their own duty and because GAAS standards provide for many judgment decisions by the auditor. Also, GAAS does not impose a duty upon the auditor to discover fraud¹. Adversaries of the accountants have argued that any violation of GAAS is negligence per se.

The majority of courts have rejected both arguments and held that GAAS and other published guidelines are only evidence of the standard of care, and violations of such standards or guidelines are only evidence of negligence, as opposed to negligence per se². As a practical matter, however, if the Plaintiff's expert convinces the jury that the auditor failed to comply with GAAS, the auditor will generally be found negligent since GAAS does, effectively, define the duties of a CPA.

GAAS can be used to create liability on the part of the accountant, without trying to prove the accountant actually had a duty to discover fraud. Statements on Auditing Standards No. 55 requires the auditor to obtain a sufficient understanding of the internal control structure of the audited entity to allow the auditor to plan the audit and determine the tests to be performed. Statements on Auditing

¹ At the present time Statements on Auditing Standards No. 53 requires the auditor to design the audit to provide reasonable assurance of detecting errors and irregularities (which includes defalcations) that are material to the financial statements.

² Maduff Mortgage Corp. v. Deloitte, Haskins & Sells, 98 Or. App. 497, 779 P.2d 484 (1990), Billy v. Arthur Young & Co., 271 Cal. Rptr 470 (Cal. App. 1990), rev'd on other grounds, 3 Cal. 4th 370, 11 Cal. Rptr. 2d 51, 834 P.2d 745 (Cal. 1992), Mishken v. Peat Marwick Mitchell & Co., 744 F. Supp. 531 (S.D.N.Y. 1990).

Standards No. 60 requires the auditor to communicate deficiencies in the internal control design of the audited entity to the organization. In our hypothetical, Maddox, Justice & Jones failed to detect and report the internal control weakness that allowed the embezzlement activities of Deion to go undetected. Thus, they violated SAS 55 and SAS 60, and though they may have not been under a duty to discover the fraud, because their negligence allowed the fraud to go undetected, Maddox, Justice & Jones is liable for the \$10,000,000.00 in losses.

III.

THEORIES OF RECOVERY FOR ACCOUNTANT NEGLIGENCE

A. THIRD-PARTY

There are primarily three schools of thought on the issue of when a third party (i.e. some person other than the accountant's client) can recover for the negligence of an accountant in the performance of an audit.

The first rule of law pertaining to accountants liability was set forth in the case of Ultramares Corp. v Touche³. In Ultramares, the court held that an accountant was only liable to persons in privity with the accountant, and the accountant was not liable to third persons damaged by their reliance upon financial statements negligently prepared by the accountant, unless one of two conditions existed: (1) the accountant was guilty of fraud, or (2) the accountant actually knew the particular person would rely upon the negligently prepared financial statements. The Ultramares rule is still followed in New York⁴, and a number of jurisdictions have adopted the rule established in Ultramares.⁵

The second view adopted by several states has been the traditional tort concept that an accountant should be liable to all persons that he reasonably could have foreseen would rely upon his work.⁶ Critics of this view argue that the accountant's liability for a thoughtless slip or blunder is unlimited.

³ 255 N.Y. 170, 174 N.E. 441 (1931)

⁴ See, Credit Alliance Corp. v. Arthur Anderson & Co., 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

⁵ See, e.g., Toro Co. v. Krouse, Kern & Co., 827 F.2d 155 (7th Cir.1987), Nortek, Inc. v. Alexander Grant & Co., 532 F.2d 1013 (5th Cir. 1976), MacNerland v. Barnes, 129 Ga.App. 367, 199 S.E.2d 564 (1973). Under the near privity rule, the accountant is still liable to a person with whom he is not in privity if the accountant knows the person for whose benefit the financial statement is being prepared. Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E.441 (1931), Credit Alliance Corp. v. Arthur Anderson & Co., 65 N.Y. 2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

⁶ See, e.g., H. Rosenblum, Inc. V. Adler, 93 N.J. 324, 461 A.2d 138 (1983), Citizens Bank v. Timm. Schmidt & Co., S.C., 113 Wis.2d 376, 335 N.W.2d 361 (1983), Touche, Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987).

The third view, adopted by a majority of jurisdictions⁷, is set forth in § 552, Restatement (Second) of Torts (1976):

§ 552. Information Negligently Supplied for the Guidance of Others

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance on the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information .

(2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it ; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The Liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any transactions in which it is intended to protect them.

The Restatement view exposes the accountant to more liability than the Ultramares rule, but to less liability than the reasonably foreseeable rule. The application of the three rules to our hypothetical scenario leads to very different results.

Under the Ultramares rule, ABC could not successfully recover against Maddox, Justice & Jones unless it could demonstrate the audits were performed for the benefit of ABC. Stated another way, if Maddox, Justice & Jones knew the audit was being performed because ABC insisted that T & J Bank submit audited financial statements with its application for fidelity bond insurance, Maddox, Justice & Jones could be liable under the Ultramares rule.

⁷ Courts which have adopted this position include, First Florida Bank, N.A. v. Max Mitchell & Co., 558 So.2d 9 (Fla. 1990), ML-LEE Acquisition Fund, L.P. v. Deloitte & Touche, 463 S.E.2d 618 (S.C. App. 1995), Boykin v. Arthur Anderson & Co., slip op., No. 1920638 (Ala. 1994), Bethlehem Steel Corporation v. Ernst & Whinney, 822 S.W.2d 592 (Tenn. 1991), Badische Corp. v. Caylor, 257 Ga. 131, 356 S.E.2d 198 (1987), Raritan River Steel Co. v. Cherry Bekert & Holland, 367 S.E.2d 609 (1988), Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co., 715 S.W.2d 408 (Tex. Ct. App. 1986), Billy v. Arthur Young & Co., 3 Cal. 4th 370, 11 Cal. Rptr. 2d 51, 834 P.2d 745 (1992), and in First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053 (5th Cir. 1990) the Federal Court, applying Louisiana law, predicted Louisiana would adopt the restatement approach.

The application of the "reasonably foreseeable" standard would unquestionably result in Maddox, Justice & Jones being liable to ABC because an insurer issuing a financial institution bond is a foreseeable user of audited financial statements.

Under the third view, the Restatement approach, although ABC would not have to establish that Maddox, Justice & Jones knew the audit was for the benefit of ABC (the standard under Ultramares), the fact that Maddox, Justice & Jones knew, generally, that the financial statements were used by T & J in a wide variety of transactions would not be enough to make Maddox, Justice & Jones liable⁹. Instead, ABC must demonstrate that the auditors knew the financial statements would be supplied to a limited group of persons, and ABC was a member of that limited group. For example, if ABC could demonstrate that T & J Bank advised Maddox, Justice & Jones that the audited financial statements would be submitted to fidelity insurers (i.e. the "class") for purpose of obtaining a financial institution bond, ABC would be entitled to recover under the Restatement approach.

The Restatement approach and the Ultramares rule are similar in that both require the auditors have at least some actual knowledge of the identity of the intended recipient of the financial statements. The actual knowledge requirement for both rules of law creates an interesting question: is the auditor liable to third-parties of whom he learns, after completion of the audit, will be recipients of the financial statements?

In First Florida Bank v. Max Mitchell & Co.⁹, although the CPA actually delivered the financial statements to the third party (the bank), the accountant did not know the identity of the recipient of the financial statements until after the audits were complete. Notwithstanding, the court held the CPA could be held liable. However, in Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.¹⁰, a case applying the Ultramares rule, the court refused to hold the accountant liable to a party whose identify was not known until after completion of the audit.

B. SUBROGEE

If the fidelity insurer is unable to state a cause of action as a third-party, the insurer should still be able to assert a claim as the equitable and/or contractual subrogee of the insured¹¹. At least one attempt has been made to defeat a subrogation claim against an accountant on the basis that

⁹ See, Restatement (Second) of Torts § 552 (1976), illustration 10.

⁹ 558 So.2d 9 (Fla. 1990).

¹⁰ 586 N.Y.S.2d 87, 597 N.E.2d 1080 (1992).

¹¹ See, e.g. Dantzier Lumber & Export Co. v. Columbia Casualty Co., 156 So. 116 (Fla. 1934), Liberty Mutual Ins. Co. v. Harris, Kerr, Foster & Co., 89 Cal.Rptr. 437, 10 Cal.App. 1100 (2d Dist. 1970), Western Surety Co. v. Loy, 3 Kan.App.2d 310, 594 P.2d 257 (1979), National Surety Corporation v Lybrand, 256 A.D. 226, 9 N.Y.S.2d 554 (N.Y. App.Div. 1939).

it was barred by the superior equities doctrine, however, this defense was flatly rejected by the court¹².

Additionally, when defending against a subrogation claim, it is clear that the accountant has the right to raise any defense that he could have raised against his client¹³. The fidelity insurer should keep in mind, however, the accountant may also try to argue the insurer was a mere volunteer and attempt to assert defenses the insurer could have asserted to the insured's claim.

Some courts have held, without distinguishing between equitable and conventional subrogation claims, that the third-party which is the target of a subrogation claim cannot raise defenses the insurer could have raised to the claim of the insured.¹⁴ Other courts have held that the mere volunteer defense can only be raised against equitable subrogation claims¹⁵, and still other courts have held the mere volunteer defense can be raised to both conventional and equitable subrogation claims¹⁶.

C. ASSIGNEE

Pursuing a malpractice claim based upon an assignment from the insured is another method available to the fidelity insurer. Some states, however, refuse to permit the assignment of a claim for professional malpractice, regardless of whether the claim is couched in contract or tort¹⁷.

¹² Federal Insurance Company v. Arthur Anderson & Co., 75 N.Y. 2d 366, 552 N.E.2d 870, 553 N.Y.S.2d 291 (1990).

¹³ Id.

¹⁴ Firestone Service Stores, Inc. v. Wynn, 179 So. 175 (Fla. 1938), National Marine Underwriters, Inc. v. Loring, 568 So.2d 1007 (Fla. 3d DCA 1987), Holyoke Mutual Insurance Company in Salem v. Concrete Equipment, 394 So.2d 193 (Fla. 3d DCA 1981).

¹⁵ See, Hartford Fire Ins. Co. v. Western Fire Ins. Co., 226 Kan. 197, 597 P.2d 622 (1979).

¹⁶ See, e.g., Commercial Union Ins. Co. v. Postin, 610 P.2d 984 (Wyo 1980), Weir v. Federal Ins. Co., 811 F.2d 1387 (10th Cir. 1987).

¹⁷ See, e.g., Washington v. Fireman's Fund, Ins. Co. 459 So.2d 1148 (Fla. 4d DCA 1984)(attorney malpractice claims are non-assignable), Florida Patients Compensation Fund v. St. Paul Fire and Marine Ins. Co., 535 So.2d 335 (Fla. 4th DCA 1988)(medical malpractice claims not assignable), Clement v. Prestwich, 114 Ill.App.3d. 479, 448 N.E.2d 1039 (1983)(attorney malpractice claims not assignable).

IV.

SUMMARY

Much to the dismay of the accounting profession, the courts generally have refused to adopt Generally Accepted Auditing Standards as the exclusive duty of care an accountant is to exercise in the performance of audits. While violations of GAAS are not negligence per se, they are evidence of negligence, and, at the present time, GAAS at least requires the auditor to design the audit to provide reasonable assurance of detecting errors and irregularities.

At a minimum, a surety can pursue its insured's negligent accountant under a subrogation theory, and the surety may be able to pursue the accountant under a third-party theory. Claims based upon an assignment should be asserted, but don't be surprised if the assignment claim is dismissed as a result of the historical bar against assigning personal choses in action.