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**THE FINANCIAL INSTITUTION BOND SURETY'S RIGHT TO
SUBROGATION OR ASSIGNMENT OF INSURED'S CLAIM
AGAINST CPA'S**

PRESENTED BY

**JAMES F. CROWDER, JR.
RUSSELL A. YAGEL
KIMBRELL & HAMANN, P.A.
Suite 900 Brickell Centre
799 Brickell Plaza
Miami, Florida 33131**

THE FINANCIAL INSTITUTION BOND - SURETY'S RIGHT TO SUBROGATION OR ASSIGNMENT OF INSURED'S CLAIM AGAINST CPA'S

Subrogation is the keystone in the bridge that allows the financial institution bond surety to enforce the rights of the institution against persons whose conduct has made such persons liable to the institution with respect to the default on the bonded obligation.

This is the case when independent auditors fail to discover employee dishonesty which over a period of several audits is the cause of loss to a bank for which the surety pays. Through subrogation, the surety may enforce the bank's rights against the independent auditor whose conduct in failing to discover the defalcations has made the auditor liable to the bank for the loss caused by the defalcations for which the surety has paid.

Subrogation against third parties may result from equity recognizing an "equitable assignment" or an "assignment by operation of law," or from a contractual provision in the financial institution bond or by formal assignment executed by the obligee bank upon payment by the surety.

The Restatement Third, Suretyship and Guaranty §28 includes the rule that enforcement of the obligee's rights against third parties through subrogation by the surety is accomplished as though the underlying obligation has not been satisfied. Comment b, points out that the purpose for the rule is ". . . to treat the secondary obligor as though its performance was consideration for an assignment of the obligee's rights, rather than performance of the secondary obligation." This is important, as . . . "performance of the secondary obligation would free the principal obligor from any duty to the obligee with respect to the underlying obligation. See § 1."¹

Squared off against the financial institution bond surety's rights of subrogation and assignment is the public policy which prevails in most states against assignment of personal torts in general and legal malpractice claims specifically. In states where there is statutory accountant-client privilege the temptation to equate that relationship to the attorney-client relationship and its protections, is often irresistible. It is for guidance in handling claims in jurisdictions where the priority of these seemingly competing rights has not been determined that this paper is intended.

¹When the provisions of the Restatement apply to particular fidelity coverages is addressed in Comment "q" to § 1.

DIFFERENCES BETWEEN INDEPENDENT AUDITORS' RELATIONSHIP WITH CLIENTS AND ATTORNEYS' RELATIONSHIP WITH CLIENTS DICTATE THAT SUBROGATION AND ASSIGNMENT SHOULD NOT BE PROHIBITED AGAINST AUDITORS

1. Assignment

Florida, like most states, recognizes the assignment of claims based in contract or statute. Although the duties breached in a malpractice case arise out of contract and the damages are pecuniary in nature, the "*unique* quality of legal services, the personal nature of the attorney's duty to the client and the confidentiality of the attorney-client relationship [have] led courts to conclude that legal malpractice claims are not assignable". Forgione v. Dennis Pirtle Agency, 701 So.2d 557-559 (Fla. 1997), *citing* Goodley v. Wank & Wank, Inc., 62 Cal.App.3d 389, 133 Cal.Rptr.83,87 (1976) (emphasis added).

Courts have found that allowing the assignment of legal malpractice claims could have a chilling effect on the attorney-client relationship and the attorneys role as an advocate of his client. Goodley v. Wank & Wank, 62 Cal.App.3d 389, 396, 133 Cal.Rptr. 83,86 (Cal.App. 1976). First Community Bank & Trust v. Kelly, Hardesty, Smith & Company, 663 N.E.2d 218,220 (Indiana Ct. of App. 1996).

However, where there is no close, personal and highly confidential relationship, there is no prohibition to allowing the assignment of a claim. *See*, Forgione v. Dennis Pirtle Agency, 701 So.2d 557 (Fla. 1997) (Court held that claims against insurance agent by the insured were assignable). A comparison of the attorney-client relationship and the independent auditor-client relationship reveals that the independent auditor does not have a close, personal and highly confidential relationship with the client as is the case between attorneys and their clients.

The attorney-client relationship is a fiduciary relation of the very highest character. Id. at 559. The attorney not only owes a duty to use skill, prudence and diligence, he also owes a duty of *undivided loyalty* to the client. Goodley v. Wank & Wank, 62 Cal.App.3d 389,396, 133 Cal.Rptr. 83,86 (Cal.App. 1976). Forgione v. Denise Pirtle Agency, 701 So.2d 557,559 (Fla. 1997)(emphasis added).

The highly confidential relationship between the attorney and client encourages full and frank communications between attorneys and their clients; furthermore, it "promotes the broader public interests in observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer's being fully informed by the client." Upjohn Company v. United States, 449 U.S. 383,388 (1980).

In contrast, the independent auditor does not owe the same undivided duty of loyalty to the client or share the same personal and highly confidential relationship as do attorneys. The independent auditors' loyalties are divided between the client and the public, with the auditors foremost duty being to the public. Before the certified public accountant may express

an opinion on the presentation of a company's financial statement, he must be "independent".² As stated by the American Institute of Certified Public Accountants, this independence "does not imply the attitude of a prosecutor but rather a judiciary impartiality that recognizes an obligation of fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditors report as in the case of prospective owners or creditors". AICPA Codification of Statements on Auditing Standards, AU § 220.02 (CCH)(1996).³

As a further note of contrast, unlike the attorney-client privilege, the accountant-client privilege was not recognized at common law. Falsone v. United States, 205 F.2d 734,739 (1953), cert. denied, 346 U.S. 864 (1953).

Moreover, the Federal Courts refused to recognize an accountant-client privilege because allowing communications between auditors and their clients to be privileged was inconsistent with the duties that the independent auditor owes to the public. In United States v. Arthur Young & Company, 465 U.S. 805, (1984), at 817-818, the United States Supreme Court stated:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes the ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

(emphasis in original).

Clearly, the independent auditor owes no undivided duty of loyalty to the client.

It may also be argued that because there is an evidentiary accountant-client privilege⁴, the accountant-client relationship has the same atmosphere of confidentiality that courts have cited in refusing to allow the assignment of legal malpractice claims. In First Community Bank & Trust v. Kelly, Hardesty, Smith & Company, 663 N.E.2d 218 (Indiana Ct. of App. 1996), the Court rejected this assertion and allowed the client to assign its malpractice claim. The Court opined that the two privileges are not the same since the attorney's high duty of confidentiality

²Independence is mandated by a statute in most jurisdictions, similar to § 473.315, Fla.Stat. (1997).

³ CPA's licensed by the State of Florida are not permitted to associate themselves with financial statements in such a manner as to imply that they are independent unless they have complied with Generally Accepted Auditing Standards. Statements of Auditing Standards published by the American Institute of Certified Public Accountants are deemed to be interpretations of such Standards. Fla. Admin. Code R. 61HA-22.002.

⁴ Such as § 90.5055, Fla. Stat. (1997)

arises out of the ethical duty of the attorney to keep the client's communications confidential, and the attorneys ethical duty to be a zealous advocate for the client. *Id.* at 221-222. The Court noted that "an attorney cannot be a zealous advocate for his client if he reveals confidential information about the client". *Id.* at 222. The Court went on to find that since Certified Public Accountants do not have a similar ethical obligation, the policy considerations that are offended by the assignment of legal malpractice claims are not offended by the assignment of accounting malpractice claims. The *Kelly* Court recognized that the only intrinsic value of the accountant-client privilege was to the client, and that the client could, therefor, assign the claim against his accountant.

Finally, the accounting profession has recognized that the transfer of a malpractice claim from the client to a third party will not, like the transfer of a legal malpractice claim, chill the relationship between the independent auditor and the client. The American Institute of Certified Public Accountants, the body charged with the self-regulation of Certified Public Accountants and the promulgator of Generally Accepted Auditing Standards, opines:

In some instances, an insurance company may commence litigation (under subrogation rights) against the member in the name of the client to recover losses reimbursed to the client. These types of litigation would not normally affect the member's independence with respect to a client who is either not the plaintiff or is only the nominal plaintiff since the relationship between the member and the client would not be affected. They should be examined carefully, however, since the potential for adverse interests may exist if the member alleges in his defense, fraud or deceit by the present management.

AICPA Professional Standards, Code of Professional Conduct, ET § 101 (CCH) (1998).⁵

The authority cited above establishes that the relationship between independent auditor and client is not the same close, personal and highly confidential relationship shared by attorney and client. Assertion that such a relationship exists is inapposite and does a disservice to the "public watchdog" role that Certified Public Accountants have proudly embraced. If auditors that are presumed to be "independent" truly have a close, personal relationship with the client, they become nothing more than management's lap puppy.

2. Subrogation

As for questions of whether there can be equitable or contractual subrogation of the financial institution surety to the obligee bank's right against negligent auditors, the case of

⁵ As noted *infra*, CPA's licensed by the State of Florida are required to adhere to Statements of Auditing Standards issued by the American Institute of Certified Public Accountants. The Statements on Auditing Standards provide that the precepts established in the American Institute of Certified Public Accountants Code of Professional Conduct have the force of professional law for the independent auditor. AICPA Codification of Statements on Auditing Standards, AU § 220.04 (CCH) (1996). Thus, the AICPA's interpretation of the "independence" requirement would not prevent an audit firm from continuing to serve as the independent auditor of a bank during a suit against the auditor by a subrogated surety.

Dantzler Lumber and Export Co. v. Columbia Casualty Co., 156 So. 116 (Fla. 1934) directly controls the issue.

In Dantzler Lumber, Columbia Casualty Co. ("Columbia"), the fidelity insurer of Dantzler Lumber and Export Co. ("Dantzler"), sought a judgment that Columbia was subrogated to the rights of Dantzler to proceed against Dantzler's accountants for failing to discover defalcations of a Dantzler employee during their audit of the company. Columbia had indemnified Dantzler for the losses sustained as a result of the defalcations. The Florida Supreme Court held that under principals of subrogation, Columbia was subrogated, pro tanto, to any right of action its insured had against Ernst & Ernst. Id. at 121.

In recent years, the reasoning and holding of Dantzler Lumber has been adopted by other jurisdictions presented with the same issue. In Federal Insurance Co. v. Arthur Anderson and Co., 552 N.E.2d 870 (N.Y. App. 1990), the New York Court of Appeals found that the surety was equitably subrogated to the rights of the insured to proceed against the insured's accountants for malpractice and rejected the assertion that the claims were barred by the superior equities doctrine. The Court, citing Dantzler Lumber, held that as a matter of law equity favored the surety. The court stated:

The rule the defendant [accountant] urges here would allow it to escape this liability simply because the victim carried liability insurance. In effect, defendant seeks to avail itself of the victim's fidelity insurance as its own liability policy without paying for it ... we see no reason in policy or fairness for adopting it. Moreover, it would conflict with the basic notion of subrogation as the mode which equity adopts to compel the ultimate payment of a debt by one who in justice, equity and good conscience ought to pay for it.

Federal Insurance Co. v. Arthur Anderson and Co., 552 N.E.2d 870, 876 (N.Y. App. 1990).

Likewise, in Western Surety v. Loy, 594 P.2d 257,261, the Court, citing Dantzler Lumber, stated:

Ample authority exists that a surety may be subrogated to the creditor's right of action against public accountants who by negligently conducting an audit fail to discover earlier defalcations, and as a result additional losses to the creditor occur which would have been prevented if the earlier defalcations had been discovered.

Western Surety v. Loy, 594 P.2d 257,261 (Kan.Ct.App. 1979). (citations omitted).⁶

CONCLUSION

⁶In spite of the longstanding rule in Florida that a surety is equitably subrogated to the rights of its insured to proceed against the insured's accountants for negligence in auditing and the continuing viability of this rule of law and the sound reasoning of the Dantzler Lumber Court which have been reaffirmed by other jurisdictions in recent years, a trial court in Florida recently found that a financial institution bond surety could not state a cause of action against its insured bank's auditor as the equitable subrogee of the bank. The question is currently on appeal.

Independent auditors, unlike attorneys who owe an undivided duty of loyalty to the client and serve as advocates of the client's cause, owe their duties primarily to the public and are not an advocate of the client. As the existing law recognizes this distinction by providing that a fidelity insurer is equitably subrogated to the rights of its insured to recover losses it has paid its insured caused by the insured's accountants' negligence in failing to discover employee defalcations in auditing the insured, no public policy can be offended by assignment or contractual subrogation of the financial institution bond surety to the same right.