SUPREME COURT OF FLORIDA

KPMG PEAT MARWICK

Petitioner,

v.

NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PENNSYLVANIA

Respondent.

_____/

CASE NO. 96,413

DISTRICT COURT OF APPEAL
3RD DISTRICT CASE NO. 98-3051

RESPONDENT'S AMENDED ANSWER BRIEF

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STATEMENT OF THE CASE

This appeal is from an Order of the Third District Court of Appeals holding that a fidelity insurer is subrogated to and can have assigned to it the rights of its insured to recover losses caused by the negligence of the insured's independent auditors.

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PENNSYLVANIA ("NATIONAL UNION") agrees with the statement of the case set forth in the Initial Brief of KPMG PEAT MARWICK ("KPMG").

SUMMARY OF ARGUMENT

In a well reasoned decision, the Third District held that NATIONAL UNION could assert claims against KPMG as the assignee and subrogee of BankAtlantic. The Third District noted that its conclusions were supported by this Court's decision in Dantzler Lumber and Export Co. v. Columbia Casualty Co., 156 So. 116 (Fla. 1934) where this Court recognized that a fidelity bond insurer that pays the claim of its insured for defalcations by the insured's employee is subrogated to the rights of the insured to recover from the insured's accountants for failing to discover the defalcations during an audit.

The Third District opined that the relationship between independent auditor and client differs from the attorney-client relationship in significant multiple respects, obviating the policy considerations that preclude the assignment of legal malpractice claims in the case of claims against independent auditors.

Specifically, the Court found that when certified public accountants perform independent audits of client's financial statements, they do not share the same close, personal and highly confidential relationship that attorneys share with their clients.

Understanding of the differences between the duties owed to clients by attorneys and independent auditors eliminates any credible argument that passage of a

statutory privilege aimed at some aspects of the accountant's functions, but which has admittedly not converted the independent auditor to a fiduciary, justifies retreating from the principles embodied in this Court's opinion in Dantzler Lumber upon which sureties and their insured's have relied for 65 years in this state.

ARGUMENT

..... CLAIMS AGAINST INDEPENDENT AUDITORS MAY BE TRANSFERRED TO A SURETY INSURER BY AN INSURED THAT HAS SUFFERED A LOSS CAUSED BY THE NEGLIGENCE OF THE INSURED'S INDEPENDENT AUDITORS AND PAID BY THE INSURER.

A. THE PRECEDENT OF THIS COURT AND OTHER JURISDICTIONS DOES NOT PROHIBIT AN INSURED TRANSFERRING A CLAIM FOR NEGLIGENCE OF ITS INDEPENDENT AUDITORS TO ITS SURETY INSURER.

All of the cases directly addressing the issue presented to the Third District and to this Court support the legal proposition that an insured's claims against its independent auditors for negligence in the performance of an audit may be transferred to its insurer by way of assignment or subrogation. In Dantzler Lumber and Export Co. v. Columbia Casualty Co., 156 So. 116 (Fla. 1934) this Court held that a surety insurer is subrogated to the rights of its insured to proceed against its insured's accountants for failing to discover employee defalcations.

In recent years, other Courts have concurred with that decision of this Court.

See, First Community Bank & Trust v. Kelly, Hardesty, Smith & Company, 663 N.E.2d 218 (Indiana Ct. of App. 1996)(allowing claim for negligence in the performance of audits to be assigned), Federal Insurance Co. v. Arthur Anderson and Co., 552 N.E.2d 870 (N.Y. App. 1990)(doctrine of superior equities does not prevent suit by surety insurer against its insured's accountants for negligence in the performance of independent audits), Fidelity & Deposit Company of Maryland v. Verzal, 361 N.W.2d 290 (Wis. Ct. of App. 1984)(surety insurer equitably subrogated to rights of insured bank to proceed against banks auditors notwithstanding that claims by the surety insurer against the bank's officers and directors are barred by superior equities doctrine). Western Surety Company v. Loy, 594 P.2d 257 (Kansas 1979)(surety insurer subrogated to rights of insured to sue insured's independent auditors).

KPMG argues that a series of decisions of this Court, which NATIONAL UNION contends appear distinguishable on their faces from issues presented by the current case, have effectively overturned Dantzler Lumber and held that no claim for professional malpractice may be transferred by assignment or subrogation. It is apparent that KPMG's view of Florida law is not shared by this Court or other Appellate Courts in this state. In Dade County School Board v. Radio Station WQBA, 731 So.2d 638 (Fla. 1999) this Court cited Dantzler Lumber and the Fifth

District Court of Appeal recently followed this Court's decision in Underwriters at Lloyds v. City of Lauderdale Lakes, 382 So.2d 702 (Fla. 1980) wherein this Court held that professional malpractice claims against physicians may be transferred by way of subrogation. See, Benchwarmers, Inc. v. Gorin, 689 So.2d 1197 (Fla. 4d DCA 1997).

KPMG argues that the 1978 enactment of the accountant-client privilege by the Florida Legislature calls the Dantzler Lumber decision into question.[1/] This argument is without merit since, as noted by one prominent scholar, the primary argument in favor of the privilege was that it would assist taxpayers in federal tax investigations. Erhardt, Florida Evidence § 5055.1, pg. 359. Thus, it seems apparent that the privilege was directed to the CPA's role as a preparer of tax returns, not as an independent auditor.

From the above, it is clear that the Third District properly followed and applied the precedent established by this Court in the Dantzler Lumber case, and the decision

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[1/] The accountant-client privilege is codified at § 90.5055. Fla. Stat. Laws 1979, c 79-202, § 15, added § 473.316, Fla. Stat. which is similar to § 90.5055 with the exception of an additional subsec. (5) pertaining to disciplinary investigations or proceedings conducted pursuant to accountancy law. In its brief, KPMG seems to imply that some form of the accountant-client privilege has been in existence since 1931 which is incorrect. The board of accountancy was established in 1931, but the privilege was first recognized in 1978.

of the Third District should be affirmed.[2/]

B. KPMG'S POSITION IS CONTRARY TO THE POSITION TAKEN BY THE ORGANIZATION CHARGED WITH THE SELF REGULATION OF CERTIFIED PUBLIC ACCOUNTANTS, THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Courts have historically refused to allow the assignment of legal malpractice claims because of the chilling effect that it would have on the attorney-client relationship. See, e.g. Goodley v. Wank & Wank, 62 Cal.App.3d 389, 133 Cal.Rptr. 83 (Cal.App. 1976), Picadilly, Inc. v. Raikos, 582 N.E.2d 338 (Ind. 1991), First Community Bank & Trust v. Kelly, Hardesty, Smith & Company, 663 N.E.2d 218 (Indiana Ct. of App. 1996). KPMG argues that since accountants have ethical obligations and constraints upon disclosure similar to that of attorneys, the relationship between independent auditor and client will likewise be impaired by allowing the transfer of malpractice claims against independent auditors. KPMG's view, however, is not shared by the body charged with the self regulation of accountants, the American Institute of Certified Public Accountants ("AICPA"). The AICPA has concluded that normally the relationship between independent auditor and client is not impaired when an insurer sues the independent auditor as the subrogee of the auditor's client.

[2/] NATIONAL UNION respectfully suggests as it is apparent that this Court has not receded from the Dantzler Lumber decision, this Court should so state and decline to accept jurisdiction over the instant action.

In its interpretations of the Rules of Professional Conduct governing CPA's[3/], the AICPA states:

> 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 § 101.08 (CCH) (1998).[4/]

It is apparent that in addition to the precedent established by this Court in the Dantzler Lumber decision, the conclusions of the Third District are supported by the body charged with the self regulation of the accounting profession.

C. THE PUBLIC POLICES THAT PRECLUDE THE TRANSFER

[3/] CPA's licensed by the State of Florida and performing audits are required to adhere to Statements of Auditing Standards issued by the American Institute of Certified Public Accountants. Fla. Admin. Code R. 61HA-22.002. 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. Codification of Statements on Auditing Standards, AU § 220.04 (CCH) (1998). The AICPA's interpretation of the "independence" requirement would not (and has not) prevented KPMG from serving as the independent auditor of BankAtlantic.

[4/] A copy of the AICPA's opinion is included in the Appendix to NATIONAL UNION's Answer Brief as item A-1.

OF LEGAL MALPRACTICE CLAIMS ARE NOT OFFENDED BY ALLOWING AN INSURED TO TRANSFER MALPRACTICE CLAIMS AGAINST ITS INDEPENDENT AUDITORS TO ITS INSURER.

Notwithstanding the precedent established by this Court in Dantzler Lumber and the position of the AICPA quoted just above, KPMG insists that the independent auditor-client relationship is "much like" (KPMG's Initial Brief, p. 13) the attorney-client relationship, and based on Forgione v. Denise Pirtle Agency, 701 So.2d 557 (Fla. 1997), claims against independent auditors may not be assigned.

As demonstrated by the following discussion, the Third District properly examined the factors discussed by this Court in Forgione and properly concluded that because of multiple significant differences in the attorney-client and independent auditor-client relationships, there is no bar to an insured transferring claims against its independent auditor to the insurer that paid a loss occasioned by the negligence of the insured's auditors.

1. The Fiduciary Relationship and Undivided Duty of Loyalty

The attorney client relationship is a close, personal and highly confidential relationship. Forgione at 559. It is a fiduciary relation of the very highest character, and the attorney owes his client an undivided duty of loyalty. Id. at 560.

In its brief filed with the Third District, KPMG recognized *that a fiduciary relationship does not ordinarily exist between the accountant and client* (Appellees

Answer Brief in the Third District Court of Appeal, pg. 8). Thus, KPMG agrees there is a major difference between the client relationships and the resulting duties owed by attorneys and independent auditors, yet KPMG offers no explanation why these inconsistencies are not fatal to the argument it put forth below and now makes in this Court.

The conclusion that independent auditors do not have a fiduciary relation of the highest character with their clients or owe their clients an undivided duty of loyalty is confirmed by previous cases that examined the duties of the independent auditor and that were cited by the Third District.

In United States v. Arthur Young & Company, 465 U.S. 805 (1984) the United States Supreme Court cited the divided duties of the independent auditor when it refused to recognize the accountant-client privilege and 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.
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> Id. at 817-818 (emphasis in original).

Likewise, in First Florida Bank v. Max Mitchell & Company, 558 So.2d 9 (Fla. 1990), this Court expanded the liability of CPA's to third party users of financial

statements not in privity with the CPA and by doing so established that the duties of the independent auditor extended to persons other than the client.[5/]

A comparison of the ethical and/or statutory provisions that require each of the two professions to maintain independence also reveals a fundamental difference between the duties owed by the two professions: the independent auditor cannot accept an audit engagement in circumstances where his loyalties to the client would be adverse to third parties; the attorney cannot accept representation of a client in circumstances where his loyalties to third parties would be adverse to the client.[6/]

The Florida statutes governing the practice of public accountancy provide that a certified public accountant may not express an opinion on the presentation of a company's financial statements unless he is independent. § 473.315, Fla.Stat. (1997). As stated by the AICPA, this independence "does not imply the attitude of a

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[5/] KPMG asserts that the Third District disregarded this Court's decision in Max Mitchell and found that independent auditors owed a duty to the public. It is evident from reading their opinion that the Third District did not conclude that independent auditors owe a duty to the public.

[6/] The considerable differences in the ethical obligations owed by the two professions to their clients was acknowledged by the AICPA in it's response to the report of the American Bar Association's Commission on Multidisciplinary Practice ("MDP"). The AICPA stated that if attorneys employed by CPA firms are required to adhere to the legal rules of conduct, including the legal profession's rules concerning conflicts of interest, it would create conflict situations in the same circumstances where none existed before. A copy of the AICPA's response to the MDP report is included in the Appendix to NATIONAL UNION's Answer Brief as item A-2.

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". Codification of Statements on Auditing Standards., AU § 220.02 (CCH)(1998)[7/]. Thus, the auditors independence requirement serves the interests of the independent auditor's client and third parties unrelated to the client that may rely on the auditor's report.

Rule 4-1.7(b) of the Rules Regulating the Florida Bar also requires an attorney to maintain independence in the exercise of professional judgment; however, as evidenced by the comments to Rule 4-1.7(b), the independence requirement of attorneys is directed to the attorney's duty of loyalty to the client and exclusively serves to protect the interests of the client. The comments state "[l]oyalty to a client is also impaired when a lawyer cannot consider, recommend, or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests".

KPMG 's admission that a fiduciary relationship does not normally exist between the independent auditor and client and the above analysis establish that independent auditors do not have a fiduciary relation of the highest character with

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[7/] A copy of the Statement on Auditing Standards is included in the Appendix to

their clients or owe their clients an undivided duty of loyalty.

2. The Highly Confidential Relationship.

KPMG argues that because of the accountant-client privilege created by §§ 90.5055 and 473.316, Fla. Stat. (1997), independent auditors have the same highly confidential relationship that exists between attorneys and their clients, making the policies that demand complete protection of the confidential relationship between attorney and client equally applicable to the independent auditor-client relationship. This argument is flawed, however, because the independent auditor does not owe the client the same duties as the attorney.

In First Community Bank & Trust v. Kelly, Hardesty, Smith & Company, 663 N.E.2d 218 (Indiana Ct. of App. 1996), a case relied upon by the Third District, the independent auditor argued that because Indiana had enacted an accountant-client privilege, the policy considerations that precluded the assignment of legal malpractice claims also prohibited the assignment of accounting malpractice claims. The Kelly Court disagreed and opined that the highly confidential relationship between attorney and client was not founded exclusively in the attorney-client privilege; it was also founded in the attorney's duty to be a zealous advocate of the client. Moreover, the attorney-client privilege was necessary for the attorney to fulfill this duty to the client

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NATIONAL UNION's Answer Brief as item A-3.

for the attorney could not be a zealous advocate without the benefit of the privilege. Id. at 221,222.

As the Kelly Court and other Courts have observed, it is the need to ensure that attorneys fulfill their duty to be a zealous advocate for the client and to act loyally to the client that demands almost absolute protection of the highly confidential attorney-client relationship. "Unlike other commercial transactions, the attorney-client relationship is structured to function within an adversarial legal system, and in order to operate within the system, the relationship must do more than simply bind together the lawyer and client. It must also repel attacks from legal adversaries". Picadilly, Inc. v. Raikos, 582 N.E.2d 338,342-343(Ind. 1991). "If an adversary can retaliate by buying up the client's malpractice action, attorneys will begin to rethink the wisdom of zealous advocacy". Id. at 342. Likewise, if legal malpractice claims were assignable, it would create conflicts of interest and potentially chill the attorneys loyalties to the client (e.g. during course of litigation plaintiff offers to take assignment of malpractice claim against defendant's attorney in settlement of claim against defendant). Id. at 343.

The Kelly Court went on to find that as the independent auditor is not an advocate of the client and does not owe the same fiduciary obligations to the client, the accountant-client privilege does not serve any duty of the independent auditor

apart from the duty created by the privilege, and the only intrinsic value of the privilege was to the client. Consequently, the Court noted that the policies that demand protection of the highly confidential attorney-client relationship do not apply to the accountant-client relationship, and the client was free to waive the privilege through the assignment of its claims. Id. at 222.

The Kelly Court's conclusion, to wit: that the accountant-client privilege does not serve any separate duty of the independent auditor, is supported by the history of the accountant-client privilege and the positions of other jurisdictions.[8/]

First, 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). In addition, the privilege is by no means recognized by all of the States.[9/] Annot. 33 A.L.R. 4th 539 (1984). The privilege was not recognized in Florida until 1978[10/], and as noted supra, the primary reason for the

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[8/] In its Initial Brief KPMG cites several cases that discuss the need to preserve confidential communications between CPA's and their clients. In these cases it does not appear the CPA's were serving as independent auditors for the client or that the dispute related to communications made during the course of providing attestation services.

[9/] The fact that privilege is not universally recognized and that audits continue to be performed in States where it is not recognized demonstrates that the privilege is not necessary for the auditor to fulfill his other duties to the client.

[10/] See, fn. 1, supra.

enactment of the privilege was to give protection to taxpayers in federal income tax investigations. Erhardt, Florida Evidence § 5055.1, pg. 359.

Even the AICPA's Rules of Professional Conduct do not prohibit the independent auditor from complying with a validly issued and enforceable subpoena or summons or applicable laws and government regulations. AICPA Professional Standards, Code of Professional Conduct, ET § 301.01 (CCH) (1998)[11/].

Since the accountant-client privilege is not founded in the same duties as the attorney-client privilege and because the accountant-client privilege does not serve any other duty owed by the independent auditor to the client, the astute observation by the Third District that "the [same] need to preserve the sanctity of the client-lawyer relationship, and the disreputable public role reversal that would result during the trial of assigned [legal] malpractice claims is simply not present in the instant case" (R.1288), succinctly sums-up the rational of the law in Florida.

3. Limitation on Substitution.

KPMG argues that the relationship between independent auditor and client is similar to the attorney client relationship because accountants cannot substitute themselves with another without the consent of the client. KPMG misconstrues the limitation on substitution. The limitation against substitution of attorneys relates to

[11/] A copy of the AICPA Professional Standard is included in the Appendix to

the attorney's role as an agent of the client. See, Goodley v. Wank & Wank, 62 Cal.App.3d 389, 395, 133 Cal.Rptr. 83,86 (Cal.App. 1976) (the attorney-client relationship is so close and personal that an attorney's authority is not delegable to other counsel without client's permission). Since the independence requirement of the AICPA prevents the auditor from serving as an agent of the client during the course of providing audit services, the independent auditor does not share the same limitation on substitution that Courts have cited as evidence of the close, personal and highly confidential relationship between attorney and client.[12/]

As demonstrated by the foregoing analysis, the Third District correctly concluded that the independent auditor and client do not have the same close, personal and highly confidential relationship that must exist between attorney and client in order for the attorney to fulfill the duties owed to the client. Moreover, because of the differences in the two relationships, the policies underlying the prohibition against the assignment of legal malpractice claims do not apply to the independent auditor-client relationship or prohibit the transfer of accounting malpractice claims arising out of the

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NATIONAL UNION's Answer Brief as item A-4.

[12/] The limitation which prohibits KPMG from substituting itself with another accounting firm is based on the well established rule of law that no contract for personal services can be assigned without the consent of the parties. See, Strehlow v. Legend Equities Corp., 727 So.2d 1076 (Fla. 4d DCA 1999), Escandar v. Southern Management and Investment Corp., 534 So.2d 1203 (Fla. 3d DCA 1989).

performance of independent audits.

D. NEITHER THE RECORD NOR THE CASE LAW SUPPORT KPMG'S ASSERTION THAT THIS CASE ILLUSTRATES THE PUBLIC POLICY REASONS THAT PROHIBIT THE TRANSFER OF ACCOUNTING MALPRACTICE CASES.

KPMG argues that this litigation illustrates how public policy will be offended if NATIONAL UNION is allowed to proceed. KPMG asserts, without record citations, that BankAtlantic did not want its auditors sued, and if this Court enforces NATIONAL UNION's rights, it will violate public policy because confidential communications between KPMG and BankAtlantic will involuntarily be disclosed during the course of KPMG defending itself in the litigation.

Contrary to the unsupported assertions of KPMG, what the record in this case does reflect is that BankAtlantic voluntarily assigned its rights to NATIONAL UNION as part of a bargained-for agreement and that BankAtlantic will share in the proceeds of any recovery obtained from KPMG up to the full amount of the bank's loss. (R.1043-1174, Tab F, ¶ 11, 12) (Covenant Not to Execute entered into between NATIONAL UNION and BankAtlantic)[13/]. The record also reveals that BankAtlantic was fully aware of the risks associated with the assignment of its claims since the accountant-client privilege was addressed in the agreement entered into between

[13/] A copy of the Covenant Not to Execute is included in the Appendix to NATIONAL UNION's Answer Brief as item A-5.

NATIONAL UNION and BankAtlantic. (R.1043-1174, Tab F, ¶ 11)(Covenant Not to Execute).

KPMG's rationale simply does not survive where, as in the instant case, the independent auditor's client (BankAtlantic) contractually agreed to the insurer being subrogated to the rights of the insured as part of the contract of insurance between BankAtlantic and NATIONAL UNION (R.653), and has voluntarily assigned its rights to the insurer. As pointed out by the amicus curiae, this aspect of giving the insurer access to salvage against what it has paid out is a key factor in determining the consideration paid by banks for this mandatory coverage.

CONCLUSION

As established by the precedent of this Court and the Courts of other jurisdictions, there are no policy considerations that preclude an insured bank from transferring to its surety insurer a claim against its independent auditors by way of assignment or subrogation, when the insurer has paid a loss occasioned by the negligence of the independent auditors. This Court has not receded from its holding in Dantzler Lumber and there are no circumstances that require this Court to revisit its decision in that case. Accordingly, NATIONAL UNION respectfully submits that this Court should decline jurisdiction over the instant case or, if it accepts jurisdiction, it should affirm the decision of the Third District.

CERTIFICATE OF SERVICE

WE HEREBY CERTIFY that a true copy of the foregoing was furnished via U.S. Mail to **Lewis N. Brown, Esq.**, Gilbride, Heller & Brown, One Biscayne Tower, Suite 1570, 2 South Biscayne Boulevard, Miami, Florida 33131, on this __ day of November, 1999.

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