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Discussion Paper: Limiting Accountants' Professional Liability Exposure



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Accounting firms are held to very high professional and ethical standards with added oversight from the American Institute of Certified Public Accountants (AICPA) and, for certain firms, the Public Company Accounting Oversight Board (PCAOB). Even with the best quality controls in place, the professional liability exposure to accountants, the accounting firm and individual partners could result in significant reduction of profits, capital and, in extreme situations, the bankruptcy of the practice.

The court decision of *Ultramares v. Touche, 174.E. 441 (1932)* contains the famous statement from Justice Cardozo that the law should not admit “to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.” This is also a reasonable guideline when considering the various responsibilities that accountants have to their clients and third parties.

This paper outlines some reasonable steps that the management of accounting firms should consider to protect their practice and limit their professional liability exposure, including adding limitation of liability provisions to their engagement letters and disclaimer language to their attestation opinions. Taking steps to limit or guard against various potential liabilities can serve as a deterrent against a client later pursuing a claim. In turn, this will create expectations of higher profits for the firm based on a decreased risk of future professional liability and lowering the cost of such risk which includes the internal cost of handling claims, loss of fees, self-insured retentions, cost of insurance as well as damage to reputation.

This paper is based in part on a review of client engagement letters as well as responses to a survey on this subject. This discussion is intended to raise awareness of various provisions that firms can consider in drafting such letters. However, it is essential that independent legal advice is sought before deciding what provisions may be appropriate for the specific client and situation.

I. Engagement Letters

A primary means of limiting future professional liability exposure is to include various limitations of liability provisions in the engagement letter. Examples of liability provisions incorporated into client agreements include the following:

- **Limit liability exposure to the amount of fees**

Limit the firm's liability exposure to the amount of the fees they will earn, or consider a higher threshold, e.g., two or three times the fees, in exchange for a higher fee, which helps show that the clause was negotiated and not forced on the client.

Example: *“You agree that the firm's total liability to you and any third party for any and all damage arising out of this agreement from any cause, including but not limited to contractual liability of the firm's negligence, errors omissions strict liability, breach of contract or breach of warranty shall not in the aggregate, exceed the fees paid to the firm during the then current term of this agreement.”*

- **Reduce the statute of limitations or repose**

Reduce the statute of limitations to one or two years. Normally statute of limitations range from two to six years depending on the state. For services related to personal tax returns, this is sometimes extended to three years.

Example: *“The client and accounting firm agree that any suit arising out of or related to this agreement must be filed in a court of proper jurisdiction within one year after the cause of action arises.”*

The agreement should also specify when the engagement is to be completed, thus starting the statute of limitations period.

Example: *“The firm’s engagement ends upon the earlier of (i) delivery of the final work product for which the firm has been engaged or (ii) where applicable, filing of the final work product for which the firm has been engaged.”*

- **Eliminate punitive damages from recovery**

Eliminate punitive, consequential, special, indirect, incidental or exemplary damages as sources of recovery. Quite often these are excluded under professional liability policies. Even if covered, they act like the “Sword of Damocles” in any future lawsuit as fear of any such award will drive firms to settle claims earlier than they would like for fear of a loss in excess of insured limits.

- **Require indemnification**

Require indemnification from clients with regard to management representations.

Example: *“You agree to indemnify and hold harmless the firm and its personnel from any claims, liabilities, costs and expenses relating to our services under this agreement attributable to false or incomplete representations of management, except to the extent determined to have resulted from the intentional or deliberate misconduct of the firm’s personnel.”*

In some cases, firms require clients to indemnify them for any third party claims, except for gross negligence or willful misconduct on behalf of the firm. The goal is to require the client to indemnify the firm for attorneys’ fees and costs, as well as the cost of judgments or awards arising from claims made against the firm by third parties. (See also “Third parties” section below).

- **Negate responsibility for the detection of fraud**

Unless specified as part of the engagement to be undertaken, include a provision that the firm is not responsible for the detection of the client’s own internal fraud.

Example: *“Our services cannot be relied on to detect errors, fraud, irregularities or illegal acts that may exist. In addition, we have no responsibility to identify or communicate significant deficiencies or material weaknesses in your internal controls. You are responsible for developing and evaluating internal controls, including, without limitation, internal controls over financial reporting and disclosure controls or procedures. Our services are not intended to assist you in developing or evaluating your internal controls and should not be relied on for this purpose.”*

- **Select jurisdiction, forum and choice of law**

Require that any litigation is to be brought in a specific jurisdiction and venue, and that a specific state law will be applied. We have also seen firms require clients to waive rights to jury trials.

Example: *“If a claim or dispute cannot be settled through mediation, each party irrevocably consents to the exclusive jurisdiction and venue of the appropriate state or federal court located in (state the county/state) and the terms of this engagement will be governed by the laws of such state, in connection with any dispute hereunder or the enforcement of any right or obligation hereunder. The firm and its client, to the extent permitted by law, each knowingly, voluntarily and intentionally waive the right to a trial by jury in any action arising out of or relating to this engagement letter or the services provided. This waiver applies to any legal action or proceeding whether sounding in contract tort, negligence or otherwise.”*

Consideration to selection of venue depends on the factors which are most advantageous from a litigation viewpoint in different states. These can include statute of limitations, convenience and the prominence of the firm in the community. Firms may also wish to consider a provision that states that if the client is unsuccessful in any claim brought against the firm, then the client will reimburse the firm for its costs to defend the claim. Such a provision may help deter a client from bringing a claim without foundation. Note also that while most insurance policies provide full worldwide cover, there are some policies that restrict cover to suits brought in the U.S., its territories, and Canada, thus excluding cover for claims outside of these jurisdictions.

- **Include option of mediation or arbitration**

Consider whether, in place of litigation, at the option of the firm, mediation or arbitration may be offered for any client disputes, especially when the dispute involves fees. We have highlighted “option,” which means the firm can decide based on the facts involved whether mediation or arbitration is to their advantage.

Mediation is the cheapest form of dispute resolution and offers both sides an independent ombudsman trying to bring both sides together to resolve the dispute, normally based on the position papers submitted by both sides. The process should be non-binding and confidential. Often courts require parties to go through this before proceeding with a court case. There are some downsides to mediation, including starting the process too early if the firm is not fully prepared, an inexperienced mediator who cannot appreciate the firm’s position, and the positions of both sides becoming entrenched or widened, unless handled carefully by the mediator.

A more debatable issue is whether to select arbitration in place of litigation. Advantages to **arbitration** include:

- Preserves confidentiality – normally this avoids adverse publicity;
- Normally achieves resolution faster than litigation;
- Avoids “hellhole” legal jurisdictions and unpredictable juries;
- Avoids awards of punitive damages;
- Some plaintiffs or their attorneys do not like arbitration so it may act as a deterrent to a claim; and
- Doesn’t establish legal precedents.

Litigation is still preferred by many firms over arbitration for various reasons, including:

- A court permits summary judgment and, while arbitrators can also so rule, they rarely do. Bear in mind, arbitrators are paid hourly and there is no financial incentive for them to settle early;
- Arbitration is not binding on third parties and firms could face increased costs if they arbitrate with the client but are separately sued by a third party. They would not be able to consolidate both actions;
- Arbitrators are reluctant to find for one side completely and often “split the baby”;
- In litigation, firms have the right to appeal which normally does not happen with arbitration; and
- Arbitrators may limit the scope of discovery that may be essential in large cases.

Firms that prefer the litigation route often require clients to also waive their right to jury trial. When considering arbitration, firms need to decide how many arbitrators they may want to use, what qualifications they should have, when and where such services are provided, which rules will govern, whether the results will be final and dispositive, what level of discovery is permitted, and who pays the costs.

- **Prohibit assignment of claims to third parties**

Require that clients cannot assign claims to third parties. Indeed, some engagement letters go further to state any work cannot be provided to third parties without approval of the firm and/or that the firm's name may not be used without authorization.

Example: *"This engagement is being undertaken solely for the client's benefit, and the parties do not intend to provide contractual rights to any other person."*

- **Require clients to pay the cost of subpoenas**

Require clients to pay the costs of responding to any subpoenas addressed to the firm.

Example: *"The client agrees to pay the firm any expense, including compensation for time and reimbursement of costs and fees, incurred in complying with or responding to any request (by subpoena or otherwise) for testimony, documents, or other information concerning the client by any governmental agency or investigative body or by a party in any litigation or dispute other than litigation or disputes by the client against the firm. This paragraph will survive termination of this engagement."*

- **Remove ability to sue individual partners and employees**

State that any claims can only be made against the firm and not against any individual partner or employee. In some cases, firms have also added a provision which states the restriction in liability by being a member of an LLP.

Example: *"The partners in a registered limited liability partnership do not have individual civil liability, directly or indirectly, including by way of indemnification, contribution, assessment or otherwise, for any debts, obligations or liabilities of or chargeable to the registered limited liability partnership or each other, whether arising in tort, contract or otherwise."*

- **Indemnify with respect to email usage**

Include an indemnification provision with respect to email usage.

Example: *"You agree that the firm shall have no liability for any loss or damage to any person or entity resulting from the use of email transmissions, including any consequential, incidental, direct, indirect or special damages, such as loss of revenues or anticipated profits, or disclosure or communication of confidential or proprietary information or missed deadlines."*

- **Discourage acting as a trustee**

Discourage the firm's partners from acting as a trustee, particularly where they intend to provide accounting services. At one point, it was common practice to act as a trustee to strengthen the client relationship, whereas now it may be detrimental as some clients feel that the trustee may have a conflict of interest if the firm's accounting services are used.

If a partner wants to act as a trustee there are a number of issues that firms should consider. These issues include:

- Why does the client want their services? If it's simply for their accounting expertise, then it's better for the firm to be hired (and probably more remunerative).

- What skill set does the partner have to perform this function, which may involve matters such as the sale and disposal of assets and investment advice? If the partner serves in this capacity the firm should consider whether they should also provide accounting services to the client.
- Does the fee from such services inure to the firm, which could increase the firm's liability?
- Does the firm require the client to indemnify the firm and its partner for claims arising out of this activity?
- Does the trustee carry errors and omissions insurance for the partner as well as other trustees?
- Does the firm's accountants' professional liability policy insure them for these activities? Sometimes trustee capacities are not covered or there are some restrictions, such as for claims arising from investment advisory work.
- Are corporate co-trustees appointed, such as a bank, to handle some of the activities?

II. Disclaimers

Another way to limit liability is in the attestation opinion provided, which is important when clients or third parties state they relied on such statements when bringing a claim.

Consider the following language from *Piedmont Family Office Fund L.P. v. Habif, Arogeti & Wynne; Robert Duncan*, Civil Action number 2010 CV 183089, a case adjudicated in Georgia, which destroyed a claim of reliance, as plaintiffs could not claim they reasonably relied on the firm's compilation work, given the explicit language in the disclaimer:

"We have not audited or reviewed the accompanying financial settlements and, accordingly do not express an opinion or any form of assurance on them. Management has elected to omit substantially all of the disclosures ordinarily included in financial statements. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions. Accordingly these financial statements are not designed for those who are not informed about such matters."

III. Enforceability

Most courts will hold that if an agreement is unambiguous, it will be enforced as written as long as it is not against public policy. Of course, each state may have their own position on what is against public policy and, as stated above at the outset of this paper, advice of experienced local counsel is urged.

It certainly helps enforceability if: (1) the client signs the engagement agreement clearly showing they understood and agreed the limitations; (2) such provisions exclude fraud or willful misconduct on behalf of the firm; (3) the client has the opportunity to discuss any restrictions with their lawyers; and (4) the firm does nothing to prevent the client from filing any action on a timely basis. Clients have the choice of many accounting firms, they can review any agreement before signing and secure advice from their counsel if they choose.

There are several cases where engagement letter provisions similar to those discussed in the prior section have been upheld:

- *TSG Water Resources, Inc. v. D'Alba & Donovan Certified Public Accountants*, 366 F. Supp. 2d 1212 (S. D. Ga.2004).

The court held that the engagement letter states that the client's audits were not "planned or conducted in contemplation of reliance by any third party with respect to any specific transaction." In addition, the engagement letter contained an indemnity clause and an exculpatory clause, which stated: "in no event shall the firm be liable to the client, whether a claim be in tort, contract and otherwise, for any consequential, indirect, lost profit or similar damages relating to the firms services provided under the engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of the firm relating to such service."

In this case an audit firm from New York was sued in Savannah, Georgia and the case went to jury. The damage limitation language was enforced by the judge. It was argued that in Georgia there is no case holding that an exculpatory clause in an engagement letter from an accounting firm is violation of public policy. Another interesting comment made in the decision is that even if, as a general rule, exculpatory language eliminating the duty of care for accountants was unenforceable, as a matter of public policy, the above language would still be enforceable. This is because the above language does not eliminate the duty of care, or preclude legal action entirely; it simply limits the type of damage that may be sought.

- *Creative Playthings Franchising, Corp v. James A. Reiser, Jr., 463 Mass.758 (2012)*

This case was brought in Massachusetts where normally a 6 year statute of limitations was the standard, but the court held that shortening the period was allowable in certain circumstances.

- *Aaron v. Deloitte Tax LLP, Docket No. 653203/2015*

This case involved a claim made against a large accounting firm in New York, where an engagement letter signed by the client specified that no action related to the engagement could be brought more than one year after the cause of action accrued. The court dismissed the lawsuit holding that it is well settled in New York that parties can contractually shorten the applicable period of limitations. It was noted that an equitable estoppel argument failed as there was no fraud on behalf of the accounting firm to have the client refrain from filing a timely action.

IV. Exceptions to Limitations of Liability

While limitation of liability clauses generally can be used, there are exceptions where prohibited by applicable law, regulation, or ethics rules. The SEC, federal banking regulators and many state insurance departments prohibit indemnification or limitation of liability arrangements. According to the AICPA Ethics interpretation 501-8, use of indemnification and liability limitation clauses that disregard the rules and requirements of regulators would be considered an ethics violation.

In addition, there are several situations where professional services firms should resist agreeing to limitation of liability requests.

- **Clients Requiring Accounting Firms to Indemnify Them**

We have seen clients, typically a governmental entity, request professional service firms to indemnify them for claims against the client caused by the firm. These should be resisted as (1) they increase liability; (2) such liabilities may not be covered under the accountants professional liability policy due to exclusions such as for contractual liability, punitive damages etc.; (3) even if the firm is only partially responsible they may have to indemnify the client for 100% of the claim; (4) they may waive the statute of limitations defense completely; and (5) the indemnity may apply not only to the client but

any company affiliated with the client. Under AICPA Ethics Ruling 102, indemnification of a client for damages, losses or costs arising from law suits, claims or settlements that relate directly or indirectly to clients, impairs independence.

- **Subcontractors Limiting Liability**

Quite often subcontractors wish to limit their liability. Their contracts should be reviewed carefully to resist any unreasonable provisions. Otherwise, firms could be fully responsible for their negligence.

- **Engagement Scope Expansion**

Most firms have internal controls that no one can work on a matter without a signed client engagement letter being on file, and that no variation in the engagement letter can take place without the approval of a person who is given the specific approval authority by the firm.

We are pleased to report many of our client firms are already incorporating several of the provisions outlined above or considering them. Many firms are looking at steps they can take from a risk management perspective to ensure that the professional liabilities they incur are proportionate to the services provided, that they do not extend responsibility to parties and matters beyond what they originally intended, and that any client disputes are reported in a reasonable time frame.

For further information, contact:

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