ACCOUNTANTS' LIABILITY DEVELOPMENTS IN 2009: ENFORCEABILITY OF ENGAGEMENT LETTER PROVISIONS AND CHOICE OF LAW

By Carol Lynn Thompson and Naomi A. Igra

In 2009, several courts addressed issues related to one of the most important documents in any accountants' liability case—the engagement letter defining the scope of the accounting firm's engagement by its client. It is increasingly common for engagement letters to include provisions addressing how any disputes that may arise between the accounting firm and its client will be resolved. Several decisions this year discussed common engagement letter provisions, including arbitration clauses and limitation of liability clauses. Another decision addressed the important threshold question of what state's law applies to professional liability claims brought by third parties against auditors.

Arbitration Clauses

Many audit engagement letters now contain arbitration clauses. There have been several decisions this year confirming the enforceability of such provisions and addressing the extent to which an accounting firm can rely on or invoke arbitration clauses in other parties' agreements.

First, in *Ernst & Young LLP v. Martin*, 278 S.W.3d 497 (Tex. App. 2009), the Texas Court of Appeals reversed a trial court decision and entered an order granting a motion to compel arbitration filed by Ernst & Young LLP (E&Y). The plaintiffs were California residents who had retained E&Y to provide tax advice. When the IRS disallowed the tax benefits claimed by the plaintiffs based on E&Y's tax advice, they sued E&Y, asserting professional malpractice, fraud, unjust enrichment, and other common law claims. E&Y moved to compel arbitration based on a clause in its engagement letter, which provided that any disputes that could not be resolved by mediation had to be resolved by arbitration. The plaintiffs claimed that the arbitration clause could not be enforced because E&Y fraudulently induced them to enter into the agreement and that the agreement itself was unconscionable. The trial court denied E&Y's motion to compel arbitration without explanation.

The appellate court reversed, holding that the trial court had no discretion to deny E&Y's motion given that the parties' engagement letter required that an arbitrator resolve even the threshold question of whether the arbitration clause applied to the parties' dispute. The court held that under the terms of the parties' agreement, they had agreed to submit questions about the applicability or enforceability of the arbitration clause to an arbitrator and that under the Federal Arbitration Act (FAA), the parties' agreement determined the scope of the issues subject to arbitration. *Id.* at 500–01. The plaintiffs argued on appeal that because E&Y's engagement letter contained purportedly unlawful terms—such as limiting the amount of recoverable damages to the fees already paid to E&Y—that the agreement was unconscionable under California law and thus E&Y could not enforce the arbitration clause. The appellate court, however, distinguished the California case law cited by the plaintiffs and concluded that a court could resolve arbitrability questions only where there was a "challenge to the agreement to arbitrate itself." *Id.* at 500. The plaintiffs, the court noted, had never argued that they did not knowingly agree to arbitration or that the specific agreement to allow the arbitrator to decide issues of arbitrability was unconscionable or invalid. Accordingly, the court concluded, the plaintiffs were bound by the express terms of the parties' arbitration clause, which required any "arguments such as those made by appellees . . . to be decided by the arbitrator." *Id.* at 501.

Ernst & Young LLP also successfully moved to compel arbitration in a second case, *Ernst & Young Ltd. Bermuda v. Quinn*, 2009 U.S. Dist LEXIS 99385 (D. Conn. Oct. 26, 2009), decided by a federal district court in Connecticut this year. That case arose out of the engagement of Ernst & Young Ltd. Bermuda (E&Y Bermuda) to provide audit services to Stewardship Credit Arbitrage Fund, LLC (SCAF or the Fund). SCAF made a large investment in Petters Group Worldwide, LLC, an entity that was subsequently alleged to be a massive Ponzi scheme. SCAF suffered a large loss on its investment with Petters. Subsequently, investors in SCAF brought claims against E&Y Bermuda and E&Y LLP in state court for breach of fiduciary duty, negligence, unjust enrichment, fraud, negligent misrepresentation, and violations of the Connecticut Securities Act based on alleged deficiencies in the audits of SCAF. *Id.* at *2.

E&Y Bermuda filed a petition to compel arbitration pursuant to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the Convention), asserting that the plaintiffs' claims had to be resolved by arbitration pursuant to the engagement letter between E&Y Bermuda and SCAF. The audit engagement letter between E&Y Bermuda and SCAF contained an arbitration clause providing that:

> [A]ny dispute or claim arising out of or relating to the Audit Services, this Agreement, or any other services provided by or on behalf of Ernst & Young or any of its subcontractors or agents to the Fund or at the Fund's request . . . shall be submitted first to voluntary mediation . . . then to binding arbitration. *Id.* at *3.

The plaintiffs argued that their claims were not subject to the arbitration provision in the engagement letter because SCAF's individual investors were not signatories to the engagement letter and their claims were distinct from any claim that SCAF might possess. The district

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court concluded that the arbitrability of the plaintiffs' claims turned on "whether those claims are derivative or direct." *Id.* at *11. If the plaintiffs' claims were derivative of the Fund's claims, then those claims amounted to a dispute or claim arising out of or relating to the services provided under the engagement letter. Conversely, if those claims were direct shareholder claims, then the plaintiffs were not bound by the engagement letter. The court held that the plaintiffs failed to allege a separate and distinct injury from that suffered by SCAF. Each of the plaintiffs' claims was premised on the notion that E&Y failed to properly perform its audits of SCAF, and the plaintiffs' alleged damages were based on the diminution of SCAF's investment funds. Accordingly, the plaintiffs' claims were derivative because the basis for their claims was a wrong to the Fund. The court further held that although the plaintiffs were not signatories to the engagement letter, because their claims were derivative, they were acting as agents of SCAF and therefore could be bound according to ordinary principles of contract and agency. *Id.* at *29.

The plaintiffs also argued that even if their claims were derivative and would otherwise be subject to arbitration, the agreement was unconscionable and therefore unenforceable. The plaintiffs claimed that the engagement letter containing the arbitration clause was unconscionable because it purported to cap damages to the amount of compensation paid to E&Y Bermuda for its services and provided that E&Y Bermuda would be liable only for willful negligence or dishonesty. However, the court found that under the Convention, an arbitration agreement is severable from the larger contract in which it is contained and that a challenge to the entire agreement does not invalidate the arbitration agreement. *Id.* at *31. Because the plaintiffs did not challenge the validity of the arbitration clause itself, the arbitration clause remained valid and the court could compel arbitration.

E&Y LLP asserted that it had no involvement in the SCAF audit reports prepared by E&Y Bermuda, but also argued that the plaintiffs' claims against it likewise were subject to the arbitration clause in the engagement letter to the extent those claims were premised on the assertion that E&Y LLP worked in tandem with E&Y Bermuda to provide audit services to SCAF. The court agreed (and the plaintiffs ultimately did not dispute) that where the plaintiffs' claims against multiple defendants were intertwined, the plaintiffs were estopped from denying that their agreement to arbitrate their claims against one defendant controlled their claims against the other defendant. *Id.* at *6–*7, n.4.

Finally, in another case involving arbitration clauses, *Arthur Andersen LLP v. Carlisle*, 129 S. Ct. 1896 (2009), the U.S. Supreme Court permitted Arthur Andersen LLP—which was not a party to the arbitration agreement at issue—to obtain a stay of the underlying action pursuant to Section 3 of the Federal Arbitration Act while it appealed a district court order denying its motion to compel arbitration based on an equitable estoppel theory.

The plaintiffs were the owners of a construction equipment company for which Arthur Andersen LLP (Andersen) had served as auditor and tax adviser. In connection with the sale of their company, the plaintiffs sought to minimize their taxes, and Andersen referred them to Bricolage Capital (Bricolage), an investment firm, and Curtis, Mallet-Prevost, Colt & Mosle, LLP (Curtis), a law firm. Upon the advice of these parties, the plaintiffs invested in a stock warrant scheme through newly created limited liability corporations (LLCs); the LLCs in turn entered into investment management agreements with Bricolage, which included an arbitration provision. Ultimately, the stock warrants turned out to be worthless, and the IRS determined that the scheme was an illegal tax shelter. The plaintiffs sued Andersen, Bricolage, Curtis, and others for fraud, conspiracy, malpractice, and breach of fiduciary duty, among other claims. Invoking Section 2 of the FAA, Bricolage filed a motion to stay the litigation pending arbitration under the investment management agreements. Bricolage, however, later filed a petition in bankruptcy, triggering an automatic stay of litigation as to Bricolage.

Andersen then moved to stay the litigation pending arbitration, arguing that under equitable estoppel principles, the plaintiffs were required to arbitrate their claims against Andersen relating to the investment agreements with Bricolage. The district court denied the motion to compel arbitration and denied a stay. Andersen sought an interlocutory appeal of the district court's order denying the stay based on Section 16(a) of the FAA, which creates an exception to the finality requirement and permits immediate appeals from orders denying stays requested under the FAA. 9 U.S.C. § 16(a)(1)(A). The Sixth Circuit held that it had no jurisdiction to hear Andersen's interlocutory appeal of the stay order because Andersen was not a party to the written arbitration agreement. The Sixth Circuit found that the language of Section 3, which provided for a stay of "any issue referable to arbitration under an agreement in writing for such arbitration," did not apply to parties seeking to expand arbitration rights through equitable estoppel rather than vindicating the written terms of the agreement. *Carlisle v. Curtis, Mallet-Prevost, Colt & Mosle, LLP*, 521 F.3d 597, 600 (6th Cir. 2008).

The Supreme Court reversed and held that by Section 16's "clear and unambiguous terms, any litigant who asks for a stay under Section 3 is entitled to an immediate appeal from denial of that motion—regardless of whether the litigant is in fact eligible for a stay." *Arthur Andersen*, 129 S. Ct. at 1900. In considering whether the party seeking a stay actually had a contractual right to enforce arbitration, the Sixth Circuit had impermissibly considered the underlying merits of the motion for a stay. Appellate jurisdiction, the Supreme Court noted, depended upon the category of the order appealed from, not the strength of the grounds for reversing that order. The Supreme Court then further addressed the substantive issue of whether a party seeking to enforce an arbitration agreement through equitable estoppel was entitled to the protections of Section 3 of the FAA. The Supreme Court held that if a written arbitration provision is made enforceable against (or for the benefit of) a third party under state contract law

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principles (such as equitable estoppel), then the FAA's protections apply.

Limitation of Liability Clauses

A recent California federal district court case involving non-audit services enforced a cap on damages recoverable for professional negligence contained in an engagement letter.[1] In *Hoot Winc, LLC v. RSM McGladrey Financial Process Outsourcing, LLC*, 2009 U.S. Dist. LEXIS 105504 (S.D. Cal. Nov. 12, 2009), the U.S. District Court for the Southern District of California issued an opinion granting partial summary judgment to RSM McGladrey Financial Process Outsourcing, LLC (RSM) and enforcing a limitation of liability clause. RSM had agreed to provide various non-audit services, including preparation of financial statements, maintaining and processing payroll, preparation of 1099 forms, and filing of tax returns for the plaintiff, Hoot Winc, LLC (Hoot Winc), a company that owned and managed restaurants and casino and gaming operations. RSM's engagement letter contained the following limitation of liability provision:

> The maximum liability of RSM for damages whether based on breach of warranty or other contract, negligence, strict liability, other tort, breach of statute or governmental rule, or any other legal or equitable theory shall not exceed one month/period's fees paid. *Id.* at *3–*4.

The letter also included a choice-of-law clause providing that the laws of the state of Minnesota would govern the agreement. Hoot Winc agreed to pay RSM $595 per restaurant per period plus $350 per period for accounting services provided to Hoot Winc itself; the total fees per period amounted to $14,035.

Hoot Winc terminated the agreement in December 2006, claiming that RSM had failed to perform the contract and had "never delivered an accurate financial statement." *Id.* at *4. Hoot Winc thereafter filed a complaint against RSM, alleging claims for professional negligence, breach of contact, fraud, and negligent misrepresentation. RSM moved for partial summary judgment, arguing that Hoot Winc's damages in connection with its non-fraud claims were restricted by the limitation of liability clause. Hoot Winc contended that the limitation of liability clause was invalid because it was overbroad and potentially encompassed intentional, willful, or wanton acts in violation of Minnesota law.

Under Minnesota law, an exculpatory clause that is "either ambiguous in scope or purports to release the benefited party from liability for intentional, willful or wanton acts . . . will not be enforced." *Id.* at *5, (*quoting Schlobohn v. Spa Petite, Inc.*, 326 N.W.2d 920, 923 (Minn. 1982)). Minnesota courts also consider two factors in determining the enforceability of exculpatory clauses: (1) whether there was a disparity of bargaining power and (2) the types of services rendered, particularly whether public or essential services were at issue. *Hoot Winc*, 2009 U.S. Dist. LEXIS 105504 at *6.

Noting that RSM only sought to enforce the exculpatory clause with respect to Hoot Winc's claims for breach of contract and negligence, the district court concluded that those claims clearly fell within the scope of the clause. The court held that although the clause arguably could be read more broadly to extend to intentional, willful, or wanton acts, its potential overbreadth did not invalidate the clause altogether. The district court also explicitly rejected Hoot Winc's argument that RSM rendered a public or an essential service so that the exculpatory clause should not be enforced. While acknowledging that accounting services were subject to state regulation, the court found that the services at issue did not affect the public well-being. The court nonetheless noted in dicta that "[t]here may be instances—e.g., where a defendant provides auditing services for a publicly-traded company—where accounting services may be deemed 'public' or 'essential.'" Thus, the court held that the limitation of liability clause was enforceable and limited the amount of damages Hoot Winc could recover for its breach of contract, negligent misrepresentation, and professional negligence claims to the extent that those claims were premised on allegations of ordinary negligence. Hoot Winc's damages were not limited, however, to the extent it proved "willful and wanton professional negligence." *Id.* at *10.

Choice of Law

The scope of an auditor's liability to non-clients for professional negligence is an issue on which there is substantial variation in state law. Some states require strict privity; some require "near privity" either under case law or by statute; still others follow the more relaxed standard articulated by the *Restatement of Torts*. As a result, which state's law applies is potentially case-dispositive. In *Harco National Insurance Co. v. Grant Thornton*, 2009 NCBC LEXIS 4 (N.C. Sup. Ct. Apr. 20, 2009), the North Carolina Superior Court concluded that the laws of the state where the audit was performed and where the audit report was delivered and disseminated would govern the scope of an accountant's liability to third parties.

In *Harco*, Grant Thornton was sued in North Carolina for negligence and negligent misrepresentation by Harco National Insurance Company in connection with its audit of the year-end 2001 financial statements of Capital Bonding Corporation (CBC). CBC was a Pennsylvania corporation whose business involved bail and immigration bonds. CBC was not an insurance company licensed to sell bonds, so it entered into arrangements with licensed insurers and acted as their agents in connection with the issuance of bonds in exchange for a portion of the premiums. Harco was an Illinois domiciled insurance company and entered into an agency and premium sharing arrangement with CBC. Before doing so, however, in October 2002, officers of Harco visited Reading, Pennsylvania, to review CBC's operations and perform due diligence. CBC allegedly provided Harco with its 2001 financial statements. Harco contended that it relied on this financial information in making a decision to enter into an agency and premium sharing agreement with CBC. However, there were no communications between representatives of Harco and Grant Thornton. Harco ultimately paid millions of dollars on bonds written in Harco's name by CBC as its agent. Harco sued Grant Thornton, alleging negligence in Grant Thornton's

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audit of CBC's financial statements.

The parties agreed that the choice-of-law issue was critical because the duty of care owed to third parties by auditors varied substantially depending on what state's law applied. Grant Thornton argued that Illinois law applied. Under the Illinois Public Accounting Act, a person not in privity with an auditor could assert a claim only if that person could demonstrate that the auditor was aware that a "*primary intent* of the client was for the professional services to *benefit or influence the person bringing the action*. . . ." *Harco*, 2009 NCBC LEXIS 4, at *9 (emphasis added). Harco could not satisfy such a standard because it did not even commence negotiations with CBC until October 2002, several months after Grant Thornton completed its audit and delivered its opinion. In moving for summary judgment based on Harco's inability to meet this standard, Grant Thornton pointed to the following facts to establish that Illinois law applied to Harco's claims:

- Grant Thornton was an Illinois limited liability partnership;
- Harco was an Illinois corporation and maintained its principal place of business in Illinois;
- Harco was supervised by the Illinois insurance regulators and filed its annual reports with the Illinois Department of Insurance;
- CBC mailed its premiums to Harco in Illinois; and
- Harco paid any losses from its Illinois bank accounts.

Thus, Grant Thornton argued that under either a place of injury or most significant relationship test, Illinois law applied.

Harco, conversely, argued that North Carolina law applied. Under North Carolina law, an auditor's liability to third parties is governed by Section 552 of the *Restatement (Second) of Torts*, which North Carolina's courts have interpreted to extend an accountant's liability to "those persons or *classes of persons* whom [the accountant] knows and intends will rely on his opinion, or whom *he knows his client intends will so rely*." *Id.* at *16 (*quoting Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E. 2d 609, 616–17 (N.C. 1988)) (emphasis added). Harco contended that North Carolina law applied because the following facts established both that Harco suffered an injury in North Carolina and that North Carolina had the most significant relationship to the claim: 1) Harco first paid losses on CBC-issued bonds in North Carolina when North Carolina seized Harco's statutory deposits from its North Carolina trust account for bonds written and breached in North Carolina; 2) Harco paid more losses in North Carolina than any state (other than New Jersey); 3) the principal officers who made decisions about execution of the agency agreement were located in North Carolina; and 4) Harco's parent company (MCM Corporation), which provided the money to pay those claims, was located in North Carolina.

The court, however, rejected the arguments of both parties and concluded that Pennsylvania law applied. The court declared that the "law of the state where an audit is performed, delivered and disseminated (the Audit State) should control the scope of liability to third parties not in privity with an accountant. In this case that state is Pennsylvania." *Harco*, 2009 NCBC LEXIS 4, at *23. The court noted that the Grant Thornton auditors who performed the audit were located and licensed in Pennsylvania, the audit was physically performed in Pennsylvania, and Grant Thornton delivered its audit opinions to CBC in Pennsylvania. The court further concluded that applying this test was appropriate because it furthered the significant public policy interest of the local states in ensuring that their licensed auditors met the appropriate standards of performance as well as protecting the interests of local companies being audited. The court also believed that its test would provide "clarity, certainty and consistency for the auditing profession and those relying on the auditor's work." *Id.* at *24.

In rejecting the place of injury test, the court wrestled with a North Carolina Supreme Court opinion—*Boudreau v. Baughman*, 368 S.E. 2d 849 (N.C. 1988)—which held that "for actions sounding in tort, the state where the injury occurred is considered the *situs* of the claim." *Harco*, 2009 NCBC LEXIS 4, at *27 (*quoting Boudreau*, 368 S.E. 2d at 853–54). The *Harco* court reasoned that negligence and negligent misrepresentation claims against accountants were really in the nature of a breach-of-warranty or contract claim rather than a tort claim because accountants are asked "to warrant that their work is done with Generally Accepted Accounting Practices and Generally Accepted Auditing Standards." *Id.* at *22. The court then concluded that its opinion was consistent with *Boudreau*, where the North Carolina Supreme Court applied the most significant relationship test to breach-of-warranty claims. *Id.* at *27.

Because neither of the parties had briefed the scope of an auditor's liability to third parties under Pennsylvania law, the court directed the parties to file summary judgment motions addressing and applying Pennsylvania law. *Id.* at *20–*21.

Conclusion

In sum, accounting firms should continually reevaluate their engagement letters to ensure that they afford the widest possible scope of protections against potential liability. And, in litigating professional malpractice and other claims on behalf of accountants, lawyers should begin their analysis of the case by closely reviewing the engagement letter to determine whether there are contract clauses that may have a significant impact on the forum in which claims are litigated, the theories available to the plaintiffs, and other strategic considerations. Often a failure to assert such contractual rights early in the litigation may lead to an effective waiver of those rights.

Carol Lynn Thompson is a partner and Naomi A. Igra is an associate with Sidley Austin LLP in San Francisco. They may be contacted at cthompson@sidley.com and nigra@sidley.com.

1. Provisions in engagement letters for audit and attest services that purport to limit an accounting firm's liability for professional negligence raise a variety of issues under professional standards and federal and state regulatory regimes that are beyond the scope of this article.

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