ADR CLAUSES IN ACCOUNTING ENGAGEMENT LETTERS

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We are surprised that Alternative Dispute Resolution ("ADR") clauses providing for mediation and/or arbitration[1] of disputes are not more widely used by the accounting profession in engagement letters with clients. An informal survey taken of accounting firms indicates that omission of ADR clauses is often not the result of conscious decisions, but rather from inertia or not wanting to disturb existing engagement letter language.

Should accountants and their clients include ADR clauses in engagement letters? We cannot answer that question. It is not the purpose of this article to advise whether ADR is right for any particular accounting firm or client. Parties must evaluate the merits based upon their own individual circumstances, experiences and preferences.

Fundamental questions must first be addressed: Are ADR clauses in engagement letters enforceable? Are ADR clauses permissible from a professional ethics perspective? While the answers to these questions may depend on the specific terms of the ADR clause utilized, the answers generally are "yes."

I. ENFORCEABILITY

There is no legal prohibition against the use of ADR clauses in engagement letters. A review of decisions by numerous state and

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[1] A common form of ADR clause provides initially for mediation and, if unsuccessful, for binding arbitration.

federal courts across the United States, addressing ADR clauses yields the following conclusions:

1. Certain accounting firms, including at least one "Big 4" firm, regularly include mediation/arbitration clauses in their engagement letters for audit and accounting services.
2. The courts have generally enforced ADR provisions in accounting engagement letters consistent with the "strong federal policy favoring arbitration."[2]
3. Judicial treatment of ADR clauses in the context of audit, tax and other accounting engagements appears to be no different than for other commercial transactions.
4. In those instances in which arbitration clauses have not been enforced, the reasons were not peculiar to audit and accounting engagements but rather the grounds for non-enforcement were those applicable to arbitration agreements generally, such as limitations on scope, lack of enforceability as against non-signatories, or waiver of right to arbitrate.

In short, reported decisions suggest nothing unique about audit or accounting services which would render ADR clauses inappropriate for the resolution of disputes arising in connection with those engagements. To the contrary, given the often technical nature of disputes arising out of audit and accounting engagements, arbitration is particularly well-suited for the resolution of disputes between accounting firms and their clients. As one state appellate court observed in enforcing an arbitration clause in an accounting malpractice action:

> Neither can we accept appellants' suggestion that a panel of arbitrators would be ill-equipped to deal with the issues, which implies that the trial court or a jury would do a better job at evaluating the evidence and applicable law. To the contrary, it would appear that in matters of complex

[2] *Denny v. BDO Seidman L.P.*, 412 F.3d 58, 68 (2d Cir. 2005). *See also*, *In re Refco Inc. Securities Litigation*, No. 07 Civ. 11604, 2008 WL 2185676 (S.D.N.Y. May 21, 2008); *Camferdam v. Ernst & Young International Inc.,* No. 02 Civ. 10100, 2004 WL 307292 (S.D.N.Y. Feb. 13, 2004); *In re Griffin Trading Co.*, 250 B.R. 667 (N.D. Ill. 2000); *Ernst & Young v. Martin*, 278 S.W.3d 497 (Tex. Ct. App. 2009); *Churchill Environmental and Industrial Equity Partners L.P. v. Ernst & Young*, 643 N.W.2d 333 (Minn. Ct. App. 2002); *Butler National Corp. v. Gerald v. Kelly & Co.*, 30 Kan. App. 2d 538 (Kansas Ct. App. 2002); *Sasaki v. McKinnon*, 124 Ohio App. 3d 613 (Ohio Ct. App. 1997); *Zutty v. Rye Select Broad Market Prime Fund L.P.*, 939 N.Y.S.2d 745 (Sup. Ct. N.Y. Co. 2011).

> litigation involving securities and investments, a panel of arbitrators versed in the issues common to that industry is better suited to review the litigation than a general jurisdiction trial court or a jury panel drawn from the general population, which is, more likely than not, untrained in the intricacies of the financial markets, sophisticated corporate accounting and their governing regulations.

Sasaki, 124 Ohio App. 3d at 617.

II. ETHICAL GUIDELINES

Past discussion about the inclusion of arbitration clauses in accounting firm engagement letters has focused, at least in the context of auditing services, on the requirement of auditor "independence." Standards of the Public Company Accounting Oversight Board ("PCAOB"), and the Securities and Exchange Commission ("SEC"), which apply to audits of financial statements of publicly owned companies that file reports with the SEC, and standards of the American Institute of Certified Public Accountants ("AICPA"), which apply to audits of the financial statements of all companies which are audited by members of the AICPA, specify that financial statements must be audited by certified public accountants who, at all times during an audit, are "independent." When performing audit engagements, independence refers not only to an auditor's state of mind, sometimes called independence in fact, but also to maintaining independence in appearance. If an auditor is to be considered independent of a client, the auditor must be able to perform an audit of the financial statements of that client with the required state of mind and an absence of proscribed relationships to enable the auditor to opine that the firm has performed an audit in accordance with PCAOB or AICPA auditing standards.

When evaluating the possible effects on clients and auditors who consider providing for mediation and/or arbitration to resolve differences between them, it is necessary to address a threshold question: Does the incorporation of an ADR provision in an engagement letter cause the auditor to lose his/her independence?

The AICPA has answered this question directly. AICPA Professional Standards, ET Section 191, "Ethics Rulings on Independence, Integrity and Objectivity," states:

> 95. Agreement with Attest Client to Use ADR Techniques
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> **.190** *Question*—Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?
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> **.191** *Answer*—No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.

In September 2006, the Professional Ethics Executive Committee ("PEEC") of the AICPA issued "Proposed Interpretation 101-16, Indemnification, Limitation of Liability and ADR Clauses in Engagement Letters, Under Rule 101, Independence." The Proposed Interpretation did not become effective, but the comments provided by the PEEC are enlightening:

> The PEEC does not believe independence would be impaired (that is, there are no threats to independence) when a member and his or her client agree to use an ADR procedure to resolve disputes between them. Specifically, ADR clauses merely determine the forum in which a dispute will be heard and decided, and facilitate dispute resolution between the member and the client.[3]

Pointedly, the PEEC went on to caution that "if an ADR clause incorporates an indemnification or limitation of liability provision that would otherwise impair independence, the ADR clause would also impair independence."[4]

The SEC requires all companies that file reports with the Commission to include annual financial statements that are audited by

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[3] Exposure Draft, Omnibus Proposal of Professional Ethics Division Interpretation and Rulings, September 8, 2006, p. 8.

[4] *Id.* In lieu of issuing the Proposed Interpretation under Rule 101, the PEEC issued an interpretation under Rule 501, *Acts Discreditable*, cautioning that some regulators, including the SEC, prohibit the use of certain types of indemnification and limitation of liability provisions in their agreements.

independent auditors. An auditor is not independent if "a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." [5]

To the SEC, an engagement letter that indemnifies an auditor from liability for his own negligent acts impairs that auditor's ability to consider, objectively and without bias, the information the auditor must address and consider when performing the audit.[6] That impairs independence. Similarly, an engagement that provides a release or indemnification from liability or holds an auditor harmless for the conduct of the audit with respect to liability or costs that result from knowing misrepresentations by management also is deemed to impair independence.[7]

The SEC's Regulation S-X and its Codification of Financial Reporting Policies do not address the effects of including ADR provisions in engagement letters. It seems reasonable to infer that an ADR provision that does not immunize an auditor from liability and costs for the auditor's negligence should not be deemed to impair independence. In other words, if a client and its auditor agree to include an ADR provision in an engagement letter, so long as the auditor must conform to auditing standards when performing the audit or else potentially incur liability for failing to do so, the auditor's objective and unbiased consideration of information addressed and considered during the audit should not be adversely affected. Clearly, whether an ADR provision is or is not included in an engagement letter, the client and the auditor may not agree to shield the auditor from liability for negligent acts if the auditor is to be independent.

III. BENEFITS OF ADR

Reasonable minds may differ about the utility of mediation and arbitration as methods of dispute resolution. Even among those who favor ADR, views are not uniform. We suggest that the potential

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[5] Regulation S-X (17 CFR Part 210), Section 210.2-01 Preliminary Note 3(b) and SEC Codification of Financial Reporting Policies, Section 601.04.

[6] SEC Codification of Financial Reporting Policies, Section 601.04.

[7] SEC Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence, Frequently Asked Questions, Other Matters, Question 4 (issued December 13, 2004).

benefits of mediation should be obvious. If successful, mediation can offer a quick and inexpensive resolution, including the potential for forms of relief not available in judicial proceedings. In addition, we believe that arbitration has particular positive attributes, which, for most participants, render arbitration preferable to litigation in the courts. These include:

1. The ability to choose an arbitrator having specific experience in the subject matter at issue, including knowledge of accounting, auditing and financial matters;
2. Greater control by the parties over the process, including the ability to establish, by a tailored pre-dispute arbitration clause, ground rules by which their dispute will be resolved;
3. Arbitration, properly managed, is usually less expensive and less time-consuming than litigation and the efficiency of the process can be enhanced by the terms of the agreed upon arbitration clause (such as, for example, by limiting the scope of discovery); and
4. Pleadings in arbitration are not publicly filed and the parties, in their arbitration clauses or thereafter, can agree to the confidentiality of the proceedings. This may be desirable not only to an accounting firm but also to a client that does not want the details of its finances or the nature of the arbitration publicly aired.

In addition to the four points above, if the parties have reservations about certain aspects of the arbitration process, they may be addressed and minimized by the provisions of the arbitration clause. For example, one element of arbitration sometimes viewed as a negative is the lack of the right to appeal. However, the parties have the power to include a pre-dispute arbitration provision expressively providing for appeal *within the arbitration process*. Certain arbitration providers, such as the American Arbitration Association, have Optional Appellate Arbitration Rules for that purpose. While adoption of these appellate procedures runs counter to the objectives of finality and necessarily prolongs the process, this demonstrates how the arbitration process can be molded by the parties to accommodate their individual needs and preferences.

IV. CONCLUSION

Accounting firms, in consultation with legal counsel and their insurance carriers, should consider the inclusion of ADR clauses in their engagement letters. If ADR clauses are employed, careful consideration should be given to specific provisions to be included to best satisfy the parties' requirements.