Client Alert

ARMSTRONG TEASDALE LLP

May 31, 2006

SECURITIES PRACTICE GROUP

LIABILITY LIMITATION PROVISIONS IN AUDIT ENGAGEMENT LETTERS - TRAPS FOR THE UNWARY

Accounting firms are increasingly attempting to limit their liability to clients by inserting limitation of liability provisions in their engagement letters for auditing services.[1] While these provisions take many forms, they can be generally categorized as an agreement by the client to:

- Indemnify the auditor against claims made by third parties;
- Hold harmless or release the auditor from liability for claims or potential claims that might be asserted by the client; or
- Limit the remedies available to the client.

These provisions are often buried in "standard" terms. Accounting firms proposing such provisions may describe them as "pro forma" or as having been routinely accepted by "other" clients. The practice is not limited to the "big four" accounting firms or to firms auditing public companies. In fact, smaller accounting firms auditing non-public companies seem to be more aggressive in requiring limitation of liability provisions in their engagement letters.

Specific examples of these limitation of liability provisions are as follows:

Release of Liability for Auditor Negligence

The client agrees not to hold the auditor liable for <u>any</u> damages, except to the extent determined to have resulted from the auditor's willful misconduct or fraudulent behavior.

Damage Limitation

The client agrees that in no event will the auditor be liable for consequential, exemplary or punitive damages.

Limitation on Time to File Claim

The client agrees that no claim will be asserted against the auditor after a specified time period that is shorter than the applicable statute of limitations.

Losses Occurring During Periods Audited

The client agrees that the auditor's liability will be limited to any losses occurring during periods covered by the audit and will not include any losses occurring in later periods for which the auditor is not engaged. Such a provision could limit the auditor's liability to the period before there is any liability.

Prohibition on Assignment

The client agrees that it will not assign or transfer any claim against the auditor to another party. Such a provision could limit the ability of another party to pursue a claim against the auditor in a sale of assets or a division of the client. This provision could also prevent the client from subrogating a claim against an auditor to the client's insurer under directors' and officers' liability or other insurance coverage and possibly result in denial of coverage.

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1 See "A Generally Accepted Accounting Principle?", <u>The Wall Street Journal</u>, page C1, March 6, 2006. This article discusses limitation of liability provisions required by auditors in their engagement letters and the disclosure of such provisions made by some public companies in their annual proxy statements.

Knowing Misrepresentation by Management

The client releases and agrees to indemnify the auditor from any claims, liabilities and costs attributable to knowing misrepresentation by management.

Indemnification for Management Negligence

The client agrees to indemnify the auditor with respect to third party claims arising from the auditor's failure to discover negligent conduct by management. Such a provision would reinforce the defense of contributory negligence in cases in which the client brings a claim against the auditor. It would also insulate the auditor from damage claims even if the reason the auditor failed to discover the negligent conduct was a failure to conduct the audit in accordance with generally accepted auditing standards or other applicable professional standards.

Damages Not to Exceed Fees Paid

The client agrees to limit the auditor's liability to the amount of fees paid to the auditor, regardless of the amount of damages. Other provisions may limit damages to a predetermined amount not related to fees paid.

Arbitration and Alternative Dispute Resolution Provisions

The client agrees that any claim against the auditor will be subject to mediation, arbitration or other alternative dispute mechanisms. By agreeing in advance to such provisions, the client is effectively waiving the right to full discovery, appellate review and other rights and protections available in court proceedings. In addition, by waiving a jury trial, the client may effectively limit the settlement value of a claim against the auditor. Arbitration clauses often include overly broad confidentiality provisions which prohibit the client from disclosing the existence, content or results of any arbitration, except for a judicial challenge to, or enforcement of, an award or as otherwise required by applicable law.

In addition to limiting a client's potential claims against an auditor, the implications of limitation of liability provisions in audit engagement letters include the following:

- On February 9, 2006, a group of federal agencies that regulate financial institutions, known as the Federal Financial Regulatory Agencies, issued an advisory stating that the inclusion of limitation of liability provisions in audit engagement letters with financial institutions could be an unsafe and unsound practice that could result in supervisory action against financial institutions that enter into such agreements.

- The Securities and Exchange Commission has stated that granting an auditor immunity from its own negligence impairs the auditor's independence.

- Inclusion of limitation of liability provisions in audit engagement letters may limit or void insurance coverage that would be otherwise available to a client.

- Publicly held companies should consider the appropriateness of disclosing limitation of liability provisions contained in audit engagement letters in their annual proxy statements when shareholders are asked to ratify the appointment of an auditor.

- Publicly held companies that agree to limit the liability of their auditors may be viewed less favorably by institutional investors.

- Overly broad confidentiality provisions in audit engagement letters can unduly limit a client's ability to make appropriate disclosures in transactional settings or when seeking a second opinion or a replacement auditor.

Boards of directors, audit committees and chief financial officers should review proposed audit engagement letters from their outside auditors and carefully consider the appropriateness and implications of any limitation of liability provisions in such engagement letters and consider rejecting or modifying such provisions.[2] Special considerations apply in the cases of public companies and financial institutions. In such reviews, assistance of counsel can be especially helpful.

2 The use of limitation of liability provisions in engagement letters is not limited to auditing firms. Such provisions are typically included in engagement letters with investment bankers, financial advisors and consultants. All such provisions should be carefully reviewed.

If you have any questions regarding these matters, you are encouraged to contact Joseph S. von Kaenel at (314) 342-8067, jvonkaenel@armstrongteasdale.com or your regular Armstrong Teasdale contact.

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