

Risk Management Techniques: Limiting Liability to the Accountant

With the Enron debacle still looming large, news of the massive mortgage loan losses are now in the headlines. Not only are financial markets around the world reeling from investors' shattered confidence, but the accounting industry, in general, has been dragged through mud. Thus, given the current climate and the constant "blame games" between the corporate executives and auditors, accountants must be more careful than ever in risk management. One way in which accountants can protect themselves from becoming part of these corporate scandals is through aggressive use of engagement letters. Engagement letters are the "contracts" between the accountant and his client, which establishes the relationship with and duties owed to the client.

There are numerous types of provisions that can be incorporated into an engagement letter to help protect accountants and limit their exposure. One such provision is a limitation of liability clause. A limitation of liability clause is typically a paragraph in the engagement letter, which establishes the extent of exposure, if any, that an accountant can be held liable for, should problems arise with the engagement. In many instances, limitation provisions will be drafted to only apply to claims brought directly by the client, not by third parties. However, accountants may choose to include other provisions, such as indemnification provisions, in the engagement letter to protect themselves from third-party claims. This article, however, focuses solely on limitation of liability provisions, and their use with clients who are not SEC registrants, where independence concerns may arise with their use. This is an important distinction to make because unlike limitation of liability provisions, indemnity clauses shift the obligation to a different party rather than limiting or denying the remedy or the damages. The considerations

underlying the validity of indemnity provisions are different, and the judgments discussed *infra* do not address their validity and enforceability.

Specifically, this article examines whether limitation of liability provisions, as used by accountants in their engagement letters, are enforceable. In considering the validity of such terms, it is important to keep in mind several general principles. First, the term “limitation of liability” is a general one, and will often take on different meanings in different contexts. As a result, it is necessary to distinguish between: (a) clauses that limit liability to no greater than a certain amount, (b) clauses that fix a certain amount as damages, (c) clauses that limit the remedy rather than the damages, and (d) clauses that totally exclude or disclaim liability for one of the contracting parties’ own negligence. Additionally, in examining the enforceability of limitation of liability clauses, the focus is not on the exact terms of the provision, or whether the exact terms at issue have been upheld by a court of law, since the language of these provisions will vary from engagement letter to engagement letter. Rather, the critical issue in examining the enforceability of such provisions is whether a properly-drafted limitation of liability clause will be upheld against contract and tort law claims, and whether there are any restrictions on enforceability.

A typical limitation of liability provision may look like this:

Accountant’s total liability for any breach of this agreement, for any failure to perform any term of this agreement, for any claims relating to or arising out of its performance of this agreement, and for its own ordinary or gross negligence (but not its reckless or willful misconduct) in any aspect of its relationship with Client shall not exceed the greater of (a) [X amount] and (b) the fees paid to and received by Accountant under this agreement. This limitation of liability excludes any and all expectation damages; damages resulting from any loss in the value of Accountant’s performance; special, consequential, and incidental damages;

damages for lost profits, savings or business opportunity; any foreseeable damages; and exemplary damages, and shall be Client's exclusive remedy.

The inclusion of limitation of liability provisions in an engagement letter is subject to much negotiation and pushback from the client because often, the client does not understand the purpose for these clauses. When an accountant performs work for a client, the accountant relies on the information and data given to him by the client. Thus, the work that the accountant performs is actually the responsibility of the client, and the client has the duty of providing accurate information to the accountant. Many times, the accounting firm is the primary target of a lawsuit because it is the only deep pocket, even though the problems arise due to the actions of others. Thus, from the accountant's perspective, limitation of liability provisions guard against limitless liability—the client's third party liabilities are not transferred to the accountant, and the accountant cannot be found solely responsible for damages that are essentially beyond their control. And, contrary to popular belief, limitation of liability provisions are not inherently harmful to the client. The client may choose whom they deal with, and consequently are in a better position to anticipate, manage, allocate, contract for, and limit third party risk.

No court, state or federal, has specifically held that accountants cannot validly include limitation of liability provisions in their engagement letters with clients. Two recent federal court decisions have held that such clauses can be used by accountants (see, *Palmer v. Ernst & Young LLP*, 22 Mass.L.Rptr. 277 (2007) and *TSG Water Resources, Inc. v. D'Alba & Donovan*, 2007 WL 4455386 (C.A.11 (Ga.)). Additionally, it appears that Illinois, California, and New York courts will enforce such provisions, as to all claims sounding in breach of contract, and with the addition of an express limitation for negligence, all claims sounding in ordinary

negligence. However, claims of fraudulent or intentional misrepresentation do not appear to be subject to limitation.

Contract

The position adopted by the Restatement of the Law of Contracts is that for a breach of contract, “[t]he injured party has a right to damages based on his expectation interest as measured by (a) the loss in the value to him of the other party’s performance caused by its failure or deficiency, plus (b) any other loss, including incidental or consequential loss, caused by the breach, less (c) any cost or other loss that he has avoided by not having to perform.” *Restatement (Second) of Contracts* § 347 (1981). The comment to this section notes that “[t]he measure of damages stated in the Section is subject to the agreement of the parties, as where they provide for liquidated damages or exclude liability for consequential damages.” *Id.* Thus, the Restatement of the Law of Contracts tends to support the validity of a limitation of liability provision.

Similarly, Illinois cases make clear that limitation of liability clauses are valid and enforceable. The general rule is that:

[w]hen parties dealing at arms-length enter into a contract, the law allows them, within reasonable limits, to shape the terms of that contract as they please. Within these limits, parties to a contract can exclude or restrict the remedies that a party may have for breach of that contract when the only losses that are suffered on account of that breach are economic losses. If the contract is breached, and economic losses are the only damages claimed, a court looks first to the contract to determine if and to what extent a party can recover those losses. If the contract is silent on the issue, the law of contract provides the answer.

Album Graphics, Inc. v. Beatrice Foods Co., 87 Ill. App. 3d 338, 349, 408 N.E.2d 1041, 1050 (1st Dist. 1980). In other words, the enforceability of limitation of liability provisions often turns

on the principle of freedom of contract. For example, in *North River Ins. Co. v. Jones*, the court concluded that the damage limitation clause for defendant's failure to provide alarm service was valid, considering the terms of the provision were clear and explicit, there were no allegations of fraud or oppression, and there was no legislation promulgated which would bar defendant from contracting for a limitation on damages predicated upon economic loss. 275 Ill. App. 3d 175, 665 N.E.2d 987, 211 Ill. Dec. 604 (1st Dist. 1995). Thus, absent evidence that "there is something in the social relationship of the parties to the contract militating against upholding the agreement," such as unequal bargaining power, or the presence of undue influence or fraud, contractual limitations on damages will be held valid in the state of Illinois. *Id.* at 180.

Like Illinois, California courts have held that limitation of liability provisions, as used in commercial contracts between business entities, will be given effect. As such, this general principle could easily apply to the use of limitation of liability provisions by accountants. One of the most frequently cited California judgments demonstrates the reluctance of courts to renegotiate the parties' terms. *Michel & Pfeffer v. Oceanside Properties, Inc.*, 61 Cal. App. 3d 433, 132 Cal. Rptr. 179 (1st Dist. 1976); *see also Fosson v. Palace (Waterland), Ltd.*, 78 F.3d 1448, 1455 (9th Cir. 1996) (holding that "a clear and unambiguous contractual provision providing for an exclusive remedy for breach will be enforced"). Specifically, in *Michel & Pfeffer*, the court refused to allow recession of a construction contract as a remedy, where the contract provided that the contractor would not be entitled to additional payments in the event of a delay and the sole remedy would be an extension of time for completion. The court reasoned that "[t]his provision clearly indicates the intention of the parties to make extension of time the exclusive remedy for delay...[and] in effect, the clause was an advance waiver of any right to rescind." *Michel & Pfeffer*, 61 Cal. App. 3d at 443. However, the court did qualify its broad

statement by saying that “where a contract expressly provides a remedy for a breach thereof, the language used in the contract must clearly indicate an intent to make the remedy exclusive.” *Id.*

In terms of volume of precedent regarding the validity of an express limitation of liability provision, New York courts lead the way. Much like Illinois and California courts, New York courts allow parties to limit their liability, “subject only to the requirement that the limitation be not so obscured as to make it probable that it would escape plaintiff’s attention.” *Florence v. Merchants C. Alarm Co., Inc.*, 51 N.Y.2d 793, 795 (1980). As a result, New York courts have held firm to the notion that a “[p]laintiff cannot escape the contractual limitations on recovery merely by recasting its breach of contract allegations as tort claims.” *See Metro. Life Ins. Co. v. Nobel Lowndes Intl.*, 192 A.D.2d 83, 93, 600 N.Y.S.2d 212, 218 (1st Dist. 1993).

Tort

It appears that a limitation on liability for ordinary negligence, like limitations on liability for damages, will also be given effect in Illinois. Under Illinois law, three prerequisites must be met before a limitation on liability for negligence will be deemed to defeat a claim: “(1) the...clause must be strictly construed; (2) with every intendment against the party who seeks immunity from liability; and (3) the clause must spell out the intentions of the parties with great particularity.” *Berwind Corp. v. Litton Indus., Inc.*, 532 F.2d 1, 4 (7th Cir. 1976). The Illinois Supreme Court has said that “[p]ublic policy strongly favors freedom to contract...[thus,] [r]egarding contracts that shift the risks of one’s own negligence to another contracting party, the general rule is to enforce...[such] contracts unless (1) it would be against a settled public policy of the state to do so, or (2) there is something in the social relationship of the parties militating against holding up the agreement.” *Harris v. Walker*, 119 Ill. 2d 542, 548, 519 N.E.2d 917, 919

(1988); *see also Manness v. Santa Fe Park Enterprises*, 298 Ill. App. 3d 1014, 700 N.E.2d 194, 233 Ill. Dec. 93 (1st Dist. 1998) (unique relationships, which militate against enforcement of the agreement, include carrier/passenger or employer/employee). Overall, these decisions demonstrate that limitation of liability provisions must be drafted with great care, so as to expressly include all possible claims that might arise out of the relationship between the parties, including third-party claims. It should be noted, however, that limitation of liability provisions “cannot protect persons from the results of their willful and wanton misconduct [or] fraud which is an intentional tort [or from] negligence...in cases where a positive duty has been imposed by law.” *Zimmerman v. Northfield Real Est., Inc.*, 156 Ill. App. 3d 154, 164-65, 510 N.E.2d 409, 415-16 (1st Dist 1986).

California also upholds the validity of an agreement to limit liability for negligence. Similar to provisions that limit damages, “[t]he language of an agreement in order to exclude liability for negligence must be ‘clear and explicit’ and ‘free of ambiguity or obscurity.’” *Philippine Airlines, Inc. v. McDonnell Douglas Corp.*, 189 Cal. App. 3d 234, 237, 234 Cal. Rpt. 423, 424 (1st Dist. 1987). Especially “[w]hen the public interest is not implicated, private parties are free among themselves to shift a risk elsewhere than where the law would otherwise place it.” *Olsen v. Breeze*, 48 Cal. App. 4th 608, 619, 55 Cal. Rptr. 2d 818, 823 (3d Dist. 1996). However, the one major exception to this principle, as stated in section 1668 of the California Code of Civil Procedure is that “[a]ll contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, violation of law, whether willful or negligent, are against the policy of the law.” However, “a contract exempting liability for *ordinary* negligence is valid where *no public*

interest is involved...and no statute expressly prohibits it.” *Blakenheim v. E.F. Hutton & Co., Inc.*, 217 Cal. App. 3d 1463, 1472, 266 Cal. Rptr. 593, 598 (6th Dist. 1990).

Like Illinois and California, New York courts also give effect to a limitation on liability for ordinary negligence, but the parties’ intent to agree on such a limitation must be exceptionally clear and unambiguous. The New York Court of Appeals has strongly emphasized the importance of using unmistakably clear language when drafting limitation of liability provisions. As the Court states, “[n]ot only does this stringent standard require that the drafter of such an agreement make its terms unambiguous, but it mandates that the terms be understandable as well.” *See Gross v. Sweet*, 49 N.Y.2d 102, 107, 424 N.Y.S.2d 365, 368, 400 N.E.2d 306, 309 (1979). Ultimately, “what the law demands is that such provisions be clear and coherent....By and large, if such is the intention of the parties, the fairest course is to provide explicitly that claims on negligence are included...That does not mean that the word ‘negligence’ must be employed for courts to give effect to an exculpatory agreement; however words conveying a similar import must appear.” *Id.* at 108. Overall, the factual scenario of a case probably plays the biggest role in determining whether a limitation of liability will be enforceable against negligence claims, i.e. whether the contract was negotiated at an arm’s length or whether both parties were sophisticated business entities. However, a limitation that purports to exclude liability for gross negligence will be held invalid. *See Sommer v. Federal Signal Corp.*, 79 N.Y.2d 540, 583 N.Y.S.2d 957, 593 N.E.2d 1365 (1992) (holding that a limitation was effective as to ordinary negligence, but ineffective as to gross negligence in an action against a fire alarm operator).

Conclusion

Based on the above three state analysis, accountants would be wise to aggressively use limitation of liability provisions, so long as the provision is clearly and concisely worded. It appears that such provisions are enforceable for ordinary negligence claims, but are not effective against claims of fraud or intentional acts. Additionally, it seems that limitations on gross negligence, or willful and wanton acts, are not permissible. In the commercial setting, it is expected that the prohibitions against the provision in breach of contract claims, such as unequal bargaining positions, should not prove to be a bar.

Limitation-of-liability provisions can be extremely effective as a negotiating tool for resolving disputes when litigation arises. Such provisions may result in complaints being filed which include counts that otherwise may not have been pled, such as fraud. However, those types of counts are usually preferable to defend against based on the higher burden of proof, as well as the need to establish a more egregious act by the accountant.

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