

Comment Upon Aspects of the December 3, 2007 Statement Submitted by Professor James D. Cox to the Advisory Committee on the Auditing Profession

By Craig P Ehrlich
Associate Professor of Law
Babson College, Babson Park MA 02457-0310
781-239-4557
ehrllichc@babson.edu

and

Joanne D Williams
Associate Professor of Accounting
Babson College, Babson Park MA 02457-0310
781-239-4278
williamsj@babson.edu

December 21, 2007

We wish to offer comment upon aspects of the December 3, 2007 Statement submitted to the Advisory Committee by Professor James D. Cox. Professor Cox discusses three approaches for mitigating the liability of an accountant: client-auditor indemnification agreements, capping liability, and increasing the net worth of accounting firms through their public ownership. The first two of Professor Cox's approaches have been the focus of our research for the past year, including a consultancy engagement on behalf of the American Institute of Certified Public Accountants. In this comment letter, we wish to elaborate upon these approaches and to bring to the attention of the Advisory Committee the pertinent common law.

A legislature can overrule the courts in nearly all matters, and the traditional views of the courts shouldn't necessarily determine the formulation of new public policy, but the Advisory Committee should be aware of the traditional judicial skepticism towards professional exculpation so that it does not inadvertently overrule precedent without being aware that it may be doing so.

We lack a clear answer to a basic and important question. May a certified public accountant performing attest services¹ use an exculpatory clause or a limitation of remedy in his or her letter of engagement? Fearing catastrophic jury verdicts for malpractice, practitioners seem to be using such language with greater frequency - particularly waivers

¹ Attest services include audits and reviews of financial statements, and may only be performed by a licensed CPA. Uniform Accountancy Act, section 3b and Comment thereto.
http://www.aicpa.org/download/states/UAA_2005_Fourth_Edition.pdf

of punitive damages.² The current trend of the law seems increasingly to favor freedom of contract and to allow professionals to limit their liability contractually.³ A recent bar journal article suggests that accountants should be able to limit malpractice liability, and that the “only concern here would be a finding that the accountant’s work involved an ‘important public interest’ because it is being performed by a certified public accountant”.⁴ This is a significant concern, however, and it might strip an auditor of the shelter of an agreement to limit liability.

We will suggest the circumstances in which such devices are given effect by the courts, and will specifically comment upon the enforceability of a punitive damages waiver.

Framing the issue

There are at least two open issues. One concerns the effect of such clauses upon an auditor’s independence. The other concerns an auditor’s exercise of due care.

It is unclear whether the use of these clauses may impair an auditor’s independence, which is the ability to act with objective and impartial judgment.⁵ The Securities and Exchange Commission concluded that an indemnity agreement between auditor and client providing the accountant full “immunity from liability for his own negligent acts” does impair the auditor’s independence, and an accountant who certifies financial statements included in a registration statement or annual report filed with the SEC may not be party to such an agreement with the registrant.⁶ The SEC may be reconsidering its position. There are only four major accounting firms in existence, and the SEC’s chief accountant has expressed concern that a large judgment might force one into bankruptcy, resulting in further consolidation of the audit profession.⁷ Other professional and regulatory groups have likewise commented. A group of federal financial regulators – the Federal Financial Institutions Examinations Council - concluded in 2006 that certain

² “Outside Audit: More Companies Are Disclosing Pacts With Auditors on Liability Caps”, Wall Street Journal (Eastern Edition), June 22, 2006, p. C4; “Outside Audit: A Generally Accepted Accounting Principle?”, Wall Street Journal (Eastern Edition), March 6, 2006, p. C1; “Outside Audit: Auditing Liability Caps Face Fire”, Wall Street Journal (Eastern Edition), November 28, 2005; Joseph Nielsen, “Defending Accounting Malpractice Actions in Connecticut: An Increasingly Difficult Task”, September 2004 Conn. B.J.171, 190.

³ In re Joan and David Halpern Inc., 248 B.R. 43 (S.D.N.Y 2000) (discussing development in law regarding indemnification of corporate director and trustees); “Defending Accounting Malpractice Actions in Connecticut”, supra, at fn 96. See too the discussion of ABA Rule 1.8h., below.

⁴ “Defending Accounting Malpractice Actions in Connecticut”, supra, at fn 110.

⁵ Conceptual Framework for AICPA Independence Standards, section 0.6, http://www.aicpa.org/about/code/et_100.html ; SEC Regulation S-X, Rule 2-01, Qualifications of Accountants, par. b, <http://www.law.uc.edu/CCL/regS-X/SX2-01.html>

⁶ SEC Codification of Financial Reporting Policies, section 602.02.f.i., reprinted in Public Company Accounting Oversight Board, Standing Advisory Group Meeting, Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters, February 9, 2006, Appendix A, http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2006/02-09/Indemnification.pdf

⁷ Remarks to the Practising Law Institute, February 9, 2007, <http://www.sec.gov/news/speech/2007/spch020907cwh.htm>

limitation of liability provisions are unsafe and unsound, and that financial institutions should not enter into external audit arrangements which include them.⁸ The National Association of Insurance Commissioners has promulgated a Model Audit Rule which states that the insurance commissioner shall not recognize as independent a CPA who has entered into an indemnity agreement with respect to the audit of the insurer.⁹

The Professional Ethics Executive Committee of the American Institute of Certified Public Accountants is presently considering the issue as well. In September, 2005, and September, 2006, the PEEC issued exposure drafts containing proposed ethics interpretations under Rule 101, Independence, addressing the impact that certain indemnification and limitation of liability provisions in client engagement letters would have on a auditor's independence. This was replaced in December 2007 by Proposed Interpretation 501-8, "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Agreements with a Client," The proposal states, "A member who enters into an agreement with a client that would place the client or member in violation of such requirements or that would cause the member to be disqualified from providing such services to the client would be considered to have committed an act discreditable to the profession."¹⁰

Independence is a concern about the auditor's integrity, not his due care, and so even if the use of these clauses does not impair an auditor's independence, there remains the separate, second question of whether a professional ought to be able to exonerate herself from liability to her client. These clauses raise concerns about encouraging carelessness, and are also inconsistent with the traditional responsibility which attends membership in a recognized profession. It is unclear on the basis of existing case law whether a court would enforce these clauses.

A quick refresher

Disclaimers, exculpatory clauses and limitations of liability are now routinely enforced in commercial transactions if they are clearly written. The courts treat indemnity clauses (the client's agreement to compensate a CPA for some or all loss sustained as a result of a claim made by a third party) similarly, since the effect in all cases is to shift a loss away from a party who would otherwise be liable.¹¹ Prof. Cox's discussion of the use of

⁸ Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, February 9, 2006, <http://www.ots.treas.gov/docs/4/480217.pdf>

⁹ Annual Financial Reporting Model Regulation, section 7A(2).

¹⁰ Exposure Draft, Proposed New Interpretation 101-16 Under Rule 101, September 8, 2006, http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Exposure+Drafts+-+Standard+Setting/2006_09_omnibus_ED.htm ; Exposure Drafts/Standard Setting, <http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Exposure+Drafts+-+Standard+Setting/>

¹¹ *Kitchens of the Oceans, Inc. v McGladrey & Pullen*, 832 So.2d 270 (Fla. App. 2002).

indemnification agreements should be expanded to consider waivers of liability and exculpatory clauses generally.

Liability for both breach of contract and for simple negligence (misbehavior that is not reckless or intentional; one cannot contract away the consequences in those cases) may be disclaimed in whole or in part and the risk expressly assumed by the counterparty. This is true for both contract liability¹² and tort liability¹³, and both are relevant here since the professional malpractice of an accountant is a blend of the two.¹⁴

However, indemnity and limitations clauses will not be enforced by the courts if they are found to be unconscionable (e.g., invoked against a consumer; the doctrine of unconscionability is almost irrelevant to a transaction between two businesses, or at least to transactions between sophisticated entities) or offend public policy. The latter exception includes, among many other things, the ability of a professional to eliminate or limit liability for malpractice. As a matter of public policy, the courts have been cautious in allowing members of a recognized profession to limit liability to patient or client, the very idea being antithetical to their status as a professional.¹⁵ Doctors and dentists and lawyers may not use these clauses. Engineers, on the other hand, usually may use limitations clauses. Stockbrokers may use exculpatory clauses and sometimes investment advisers may, though the courts are split. It is unclear whether a CPA may contractually limit its liability to the client.

Prior to the demise of Laventhol & Horwath in 1990, the accounting profession required accountants to form general partnerships on the grounds that a professional should stand by his work and not be shielded from the cost of mistakes. Enforceability will also depend upon whether the courts perceive the terms of the engagement to be freely bargained or whether, instead, there is an absence of meaningful choice. The audit market for clients with sales above \$100 million is “highly concentrated”.¹⁶

¹² See, e.g., Uniform Commercial Code 2-316 (warranty disclaimers), and 2-719 (limitations of liability).

¹³ Restatement (Second) Contracts, §195 (1981); Restatement (Second) Torts, § 496B (1965).

¹⁴ See, e.g., *Cenco v Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982).

¹⁵ On the special status of a professional, see *Stiner v Yelle*, 174 Wash. 402 (1933)(exempting professions from excise tax upon “business activities”); *In re Freeman*, 34 N.Y.2d (1974)(minimum fee schedule for lawyers not violative of state antitrust law), but see *Goldfarb v Virginia State Bar*, 421 U.S. 773 (1975) (minimum fee schedule violated federal Sherman Act); *Shapero v Kentucky Bar Ass’n*, 486 U.S. 466, 480-492 (1988)(O’Connor, J, dissenting from holding allowing lawyers to solicit business by sending letters to potential clients on grounds that the pursuit of a profession entails tempering one’s pursuit of economic success).

¹⁶ Lawrence A. Cunningham, “Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels”, 106 Colum. L.Rev. 1698, 1717 (2006). See also Eric L. Talley, Cataclysmic Liability Risk Among Big Four Auditors, 106 Colum. L.Rev. 1641, 1692 (2006) (“The loss of yet another Big Four firm would, if clients simply switched to one of the remaining dominant firms, cause the Herfindahl index for the industry to shoot well past 1,800, a point that the Department views as ‘highly concentrated.’”)

A closer look at an accountant's use of these clauses

When an accountant is performing ordinary commercial services, e.g., management consultancy, there is no special concern and such clauses ought to be routinely enforced.¹⁷ But when a licensee operating in a licensed firm performs attest services - something that only such a person may do - does the public interest require that indemnities and limitations of liability be disallowed? There is a strong public interest at stake.¹⁸

May an accountant say to the client, "You may purchase my time but I make no promise about the quality of what I will do"? While an accountant may define the scope of the mission in the engagement letter (e.g., "you've hired me to do a compilation but not an audit"¹⁹), or specifically and clearly qualify its opinion²⁰, the engagement must be performed according to professional standards, and the accountant may not turn a blind eye to a pathology he or she may notice.²¹ In *Robert Wooler Co. v Fidelity Bank*, 330 Pa. Super. 523, 533 (1984), the court stated-

Touche Ross' agreement to perform unaudited services was not a shield from liability if it failed to warn its client of known deficiencies in the client's internal operating procedures which enhanced opportunities for employee defalcations. Its agreement, in the absence of specific language relieving it from acts of negligence, did not relieve it from liability for ignoring suspicious circumstances which would have raised a 'red flag' for a reasonably skilled and knowledgeable accountant.

The language of the Wooler court suggests that an exculpatory clause between auditor and client might be enforced. The auditor's engagement agreement in *Kitchens of the Oceans, Inc. v McGladrey & Pullen*, 832 So.2d 270 (Fla. App. 2002) contained the following hold harmless clause-

¹⁷ See, e.g., *Farris Engineering v The Service Bureau*, 406 F.2d 519 (3d Cir. 1969) (limitation of liability in data processing services contract enforceable); *IBM v Catamore Enterprises*, 548 F.2d 1065 (1st Cir. 1976) (enforcing provision in IT services agreement limiting liability to one year); *Hong Kong Export Credit v Dun & Bradstreet*, 414 F. Supp. 153 (S.D.N.Y. 1980) (enforcing exculpatory clause in subscription agreement for credit reporting services).

¹⁸ *United States v Arthur Young*, 465 U.S. 805, 817-18 (1984) ("the independent auditor assumes a *public* responsibility"). Cf., "Street Sleuth: Booming Audit Firms Seek Shield From Suits", *Wall Street Journal* (Eastern edition) Nov. 1, 2006, p. C1 (Auditors "are the outsiders we rely on. It's tough to have that responsibility, but that's what they're getting paid for.")

¹⁹ *Evans v Israeloff*, 617 N.Y.S. 2d 899 (App. Div. 1994) (no justifiable reliance upon compilation); *Stephens Ind. v Haskins and Sells*, 438 F.2d 357 (10th Cir. 1971) (both engagement and opinion clearly stated limited scope of undertaking).

²⁰ *CIT Financial Corp. v Glover*, 224 F.2d 44 (2d Cir. 1955); but see *Herzfeld v Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 35-36 (2d Cir. 1976) (qualification too general).

²¹ *United States v Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964) (labeling a false financial statement as "pro forma" no defense; "men holding themselves out as members of these ancient professions should [not] be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen").

[Client] hereby indemnifies [auditors] and its partners and employees and holds them harmless from all claims, liabilities, losses, and costs arising in circumstances where there has been a knowing misrepresentation by a member of [client's] management, regardless of whether such person was acting in [client's] interest. This indemnification will survive termination of this letter.

Rather than decide whether auditors may use such clauses at all, the court decided the case on narrower grounds and held the clause unenforceable against a claim of professional negligence because it did not specifically use the word "negligence".²² As a leading treatise notes, "(m)any cases bypass the issues by holding that the contested clause lacks sufficient clarity..."²³ A similar issue arose in two cases against a dental clinic. In the first case, Abramowitz, the court held the clinic's release unenforceable because it did not use the correct language-

the language employed ... merely undertakes to release and save harmless the defendant, its doctors and students "from any and all liability arising out of or in connection with any injuries or damages which [the plaintiff] may sustain while on its premises or as a result of any treatment in its infirmaries". The word "negligence" is never mentioned, and construing the language strictly against its drafter, it simply cannot be said to unmistakably express an intention on the part of the plaintiff to absolve the defendant of liability for its own negligence.²⁴

The dental clinic revised its release accordingly, and in the second case, Ash, the court had to confront the issue squarely: may dentists use such clauses at all? The court held that they may not-

even aside from the deleterious effect which a decision upholding such an agreement could have on the public-at-large, the individual responsibility bestowed upon defendants by the physician-patient relationship, in the context of the disadvantageous position from which plaintiff necessarily entered into the agreement, militates strongly against its propriety.²⁵

²² 832 So.2d at 273

²³ 7 Arthur Corbin, Corbin on Contracts, section 29.10, 423 (Rev. ed. 2005), cited in Matthew Bauer, "Making Sense of Maritime Exculpation Clause Jurisprudence", 22 T.M. Cooley L. Rev. 309 (2005).

²⁴ Abramowitz v NYU Dental Center, 110 A.D. 2d 343, 347 (2nd Dept. 1985).

²⁵ Ash v NYU Dental Center, 164 A.D.2d 366, 372 (1st Dept. 1990).

European law

As a general matter, European auditors may not enter into contractual limitations of liability.²⁶ However, pursuant to new legislation in the Companies Act 2006, effective October 2008, companies in the UK will be able to agree on a limit on the auditors' liability arising from an audit for the financial year specified in the agreement.

Use of punitive damages waivers

Simple negligence will not support an award of punitive damages.²⁷ Since courts will not enforce a clause that eliminates or limits liability for intentional or reckless misconduct, it is not clear whether a court would enforce a punitive damage indemnification or limitation of liability provision.²⁸ The authorities cited in fn 27 may stand only for the uncontroversial proposition that one may not contract out of liability for actual damages for intentional or reckless misconduct. May one contract out of liability for punitive damages? This answer also seems to be no, as the following authorities indicate.

The Los Angeles County Bar Association Professional Responsibility and Ethics Committee issued a 1997 opinion that lawyers may not use punitive damage waivers in their retainer agreements. Ethics Opinion No. 489, April 28, 1997.

In *Stark v Sandberg, Phoenix & von Gontard*, 381 F.3d 793, 800 (8th Cir 2004), the court held that Missouri state law does not permit a waiver of punitive damages:

The plain language of the arbitration agreement states the "borrower and lender expressly waive any right to claim [punitive damages] *to the fullest extent permitted by law.*" Thus, the agreement only effected a *limited* waiver of punitive damages, that is, punitive damages were waived only if the governing law permitted such a waiver. Conversely, if the law did not permit the waiver of punitive damages, the arbitration agreement unambiguously preserved the right to claim them.

²⁶ Annex II to the Commission Staff Working Paper: Consultation On Auditors' Liability And Its Impact On The European Capital Markets, January 2007, section 3.2, http://ec.europa.eu/internal_market/auditing/docs/liability/consultation_annex2_en.pdf

²⁷ Prosser and Keeton on the Law of Torts, 5th ed., 1984, pp. 9-11.

²⁸ Restatement (Second) Contracts, § 195(1); *Jones v Dressel*, 623 P.2d 370, 376 (Colo. 1981) ("in no event will such an agreement provide a shield against a claim for willful and wanton negligence"); *Sommer v Federal Sign Corp.*, 79 N.Y.2d 540, 554 (1992); cf. David S. Schwartz, "Understanding Remedy-Stripping Arbitration Clauses: Validity, Arbitrability, and Preclusion Principles", 38 U.S.F. L. Rev. 49, 53-54 (2003) (discussing the policy against enforcing remedy-stripping clauses); Thomas J Stipanowich, "Punitive Damages and the Consumerization of Arbitration", 92 Nw. U.L.Rev. 1, 34, (1997)"Just as individuals cannot penalize by contract, they cannot generally avoid punitive damages for prospective acts or omissions through contract."). Section 195 (1) of the Restatement of the Law, Second, Contracts, 1981, states that a party may not by contract exempt itself "from tort liability" for harm caused intentionally or recklessly. The Comments & Illustrations do not state whether this refers to liability for actual damages or punitive damages or both.

Under Missouri law "there is no question that one may never exonerate oneself from future liability for intentional torts or for gross negligence, or for activities involving the public interest." *Alack v. Vic Tanny Int'l of Mo., Inc.*, 923 S.W.2d 330, 337 (Mo. 1996) (citing *Liberty Fin. Mgmt. Corp. v. Beneficial Data Processing Corp.*, 670 S.W.2d 40, 48 (Mo. App. 1984) (in turn citing 6A Corbin on Contracts, § 1472 (1962))). An attempt to procure a waiver of punitive damages is an attempt to exonerate oneself from future liability for intentional torts or gross negligence, because the remedy of punitive damages would otherwise be available for such acts. Thus, Missouri law did not permit EMC to exonerate itself from liability for the intentional torts committed against the Starks by procuring the punitive damages waiver, and the arbitrator did not exceed his authority in awarding punitive damages.²⁹

To the same effect, the Supreme Court very narrowly read an arbitration clause which forbade an award of punitive damages, so as not to preclude a claim for treble damages under the RICO statute-

Two of the four arbitration agreements at issue provide that "punitive damages shall not be awarded [in arbitration]"; one provides that "the arbitrators . . . shall have no authority to award any punitive or exemplary damages; and one provides that "the arbitrators . . . shall have no authority to award extra contractual damages of any kind, including punitive or exemplary damages . . . ,". Respondents insist, and the District Court agreed, that these provisions preclude an arbitrator from awarding treble damages under RICO. We think that neither our precedents nor the ambiguous terms of the contracts make this clear.³⁰

The narrow reading evidences judicial discomfort with such remedy stripping clauses.

The National Association of State Boards of Accountancy sent a comment letter dated November 2, 2006 regarding the AICPA's September 8, 2006 Proposed Interpretation 101-16. In it, the NASBA stated its opposition to all clauses that would allow the auditor

²⁹ See too, *State ex rel. Dunlap v Berger*, 567 S.E.2d 265, 280 (W.Va. 2002), an arbitration clause in a standard form consumer agreement that prohibited an award of punitive damages "clearly unconscionable"; *Ex Parte Thicklin*, 824 So.2d 723, 730-734 (Ala. 2002), which also involved a consumer transaction and a waiver of punitive damages in an arbitration clause. Held: "the portion of the arbitration clause in Thicklin's contract that prohibits the arbitrator from awarding punitive damages is void". *Carll v. Terminix Int'l Co., L.P.*, 793 A.2d 921 (Pa. Super. 2002), homeowners and minor children sued for physical injuries suffered through the negligent application of pesticides; held, "it would be unconscionable and against public policy to compel arbitration". *Id.*, at 924. Since the award of punitive damages was barred, the "entire arbitration clause, as a whole, must fail." *Id.*, at 926.

³⁰ *Pacificare Health Systems v Book*, 538 U.S. 401, 405 (2003). See too, *Investment Partners v Glamour Shots Licensing*, 298 F.3d 314 (5th Cir 2002), (a punitive damage waiver in the arbitration clause did not bar an antitrust treble damages claim); *Larry's United Super v Werries*, 253 F.3d 1083 (8th Cir 2001) (whether prospective waiver of punitive damages violates policy underlying RICO is for arbitrator to decide).

or auditing firm to limit liability, urging that all would impair independence. The NASBA further stated that the client must be able to pursue punitive damages for egregious misconduct by the auditor, and that the client's ability to do so must not be limited.³¹ In contrast, the Federal Financial Institutions Examinations Council hesitated in early 2006 to conclude that waivers of punitive damages are unsafe and unsound. Theirs was not a conclusion on the merits, though. The FFIEC merely decided to keep the matter under advisement because of the position then taken by the AICPA - that such clauses would not impair independence.³²

What if the remedy stripping clause is contained within an arbitration clause, expressing an intention to strip the arbitrator of the power to award punitive damages - as many purport to do? Might an audit firm accomplish indirectly what cannot be contracted for directly? Dicta in two cases suggest that a punitive damages waiver set forth within an arbitration clause might be effective. The courts are mistaken in their speculation, and both seriously misstate the law, I believe.

Reconsider *Stark v. Sandburg, Phoenix & von Gontard*, supra, 381 F.3d at 800, in which the court noted -

“The plain language of the arbitration agreement states the ‘borrower and lender expressly waive any right to claim [punitive damages] *to the fullest extent permitted by law.*’” (emphasis in original)

Since governing Missouri law did not permit one to exonerate himself from future liability for intentional torts, gross negligence, or for activities involving the public interest, the court held this waiver ineffective to bar the arbitrator's award of punitive damages. Having disposed of the matter, the court then speculated that had the parties clearly expressed their intention for the arbitration to be governed not by Missouri law but by the Federal Arbitration Act alone, “the punitive damages waiver might have barred any such award.” *Id.* With respect, the court's speculation is mistaken. The F.A.A. provides that an arbitration agreement is “enforceable, subject only to any contract defense recognized under state law.” *Sanderson Farms v Gatlin*, 848 So.2d 828, 834 (Miss. 2003). If a waiver of punitive damages is not enforceable under state contract law, then wrapping it inside an arbitration clause will not work either. A finding of unconscionability is the usual ground for a court to find a contract-type defect in an arbitration clause, but “any contract defense” cuts a broad swath.

Moreover, no case holds such a waiver enforceable. The *Stark* court cited its earlier decision in *UHC Management Co. v Computer Sciences*, 148 F.3d 992 (8th Cir. 1998), in support of the dictum. That decision held only that the parties' agreement to arbitrate did not clearly express an intention to preclude the application of the F.A.A. in favor of

³¹The NASBA letter is available at http://www.aicpa.org/download/ethics/SummarySept06_101-16_Comments12-14-06.pdf

³² Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters, February 9, 2006, part III E, <http://www.ots.treas.gov/docs/4/480217.pdf>

the Minnesota Uniform Arbitration Act, and that the arbitrator's award could be modified, if at all, only under the narrow standards of the F.A.A. The UCH Management court did not address the enforceability of a punitive damages waiver in the arbitration clause. The UHC Management opinion in turn cited another 8th Circuit case, *Lee v Chica*, 983 F.2d 883 (8th Cir. 1993). *Lee* held that the arbitrators had the power to award punitive damages under the rules of the American Arbitration Association, which the parties had chosen to govern their arbitration.

The Supreme Court's decision in *Mastrobuono v Shearson Lehman Hutton*, 514 U.S. 52 (1995) has been cited, in a footnote by the D.C. Circuit Court of Appeals, as authority for the proposition that "provisions in arbitration agreements that prohibit punitive damages are generally enforceable." *Investment Partners v Glamour Shots*, 298 F.3d 314, 318 (D.C. Cir. 2002). This dictum is likewise mistaken. The only issue before the *Investment Partners* court was whether a punitive damages waiver set forth in an arbitration clause barred the arbitrator from awarding treble damages available under the Sherman Act (an issue later addressed by the Supreme Court in *Pacificare Health Systems*). The court held that treble damages are not punitive damages and that the waiver was therefore irrelevant to the case. The D.C. Circuit's footnote about *Mastrobuono* is dictum, and it is also a misreading of *Mastrobuono*. The Supreme Court decided *Mastrobuono* as matter of a simple contract interpretation, holding only that "the text of the arbitration clause itself does not support – indeed, it contradicts – the conclusion that the parties agreed to foreclose claims for punitive damages." 514 U.S. at 61. The Court did not speculate as to whether a clause which did foreclose such claims would be enforceable.

Summary and conclusions

Members of core professions, such as physicians and attorneys, may not use prospective waivers of liability. Engineers and architects may however use limitation of liability clauses - at least when the losses are economic and do not involve personal injury - but may not wholly exculpate themselves of liability to their clients. The cases concerning financial services providers are mixed. One view is that the parties ought to be free to strike whatever bargain they themselves think best, and that judicial policing of contract terms should be limited to an examination of the bargaining process. The other view, one that is perhaps no longer in favor outside of the physician and attorney cases, is that members of a recognized profession are not ordinary merchants but have social responsibilities that cannot be disclaimed. This view may be the vestige of a different time.

On one hand, a CPA is unlike a physician. The auditor client relationship is not a fiduciary one, and the client risks only economic harm, not physical injury or death. However, it is at least arguable that a client – even a sophisticated business client - may not have a meaningful choice of terms, given the paucity of large audit firms and the essential nature of the attest service rendered by a licensee operating in a licensed firm. It is beyond argument that the auditor discharges a public responsibility.

Following the lead of the engineering cases, the enforcement of a limitation on liability would seem to have a much better chance of being enforced than an outright exculpation of liability.

A punitive damages waiver may not be enforceable. Punitive damages are awarded to deter misconduct that is intentional, deliberate, aggravated or outrageous, and courts will not enforce a clause that eliminates or limits liability for intentional or reckless misconduct.