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Federal Financial Institutions Examination Council
3501 Fairfax Drive, Room 3086
Arlington, VA 22226

Dear Program Coordinator:

Deloitte & Touche LLP is pleased to respond to the request for comments from the Federal Financial Institutions Examination Council ("FFIEC" or "Council") on its *Proposed Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters*, 70 Fed. Reg. 24576 (May 10, 2005) (the "Proposal").

I. Introduction

We share the underlying goal of the Proposal to protect the "objectivity, impartiality, and performance" of the financial institutions' external auditors. We believe that auditor independence is essential to the quality and transparency of financial reporting. Nevertheless, in light of existing law, regulations, and the comprehensive auditor independence standards set by the U.S. Securities and Exchange Commission ("SEC"), the Public Company Accounting Oversight Board ("PCAOB"), and the American Institute of Certified Public Accountants ("AICPA"), we believe that the Proposal is unnecessary. The Proposal is also counterproductive: the contract provisions that the Proposal seeks to eliminate serve legitimate business purposes; there is no adequate basis for prohibiting regulated financial entities and their external auditors from freely contracting to employ such provisions to allocate risk.

We first offer general comments regarding the extensive regulation of auditors with respect to independence standards by a number of federal entities. We also discuss the necessity of allowing auditors and financial institutions to have the flexibility to adopt contract provisions that are permitted under SEC, PCAOB, and AICPA standards, and the potential impact of impairing their ability to do so. We then offer some specific comments regarding five of the provisions addressed by the Proposal: alternative dispute resolution, waiver of jury trial, non-assignability provisions, indemnification provisions for the knowing misrepresentations of management, and punitive damages provisions.[1]

II. General Comments

A. Auditors Are Already Extensively Regulated With Respect To Provisions In Engagement Letters.

The Proposal, in attempting to further the regulators' "safety and soundness" goals, raises issues of auditor independence. But the Proposal's blanket admonition against "external

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1 We wish to emphasize at the outset that, if any version of the Proposal is adopted, its scope should be clearly limited to external audit engagement letters only, and not to contracts, for example, for non-audit services. In certain places, the Proposal is unclear on this point. *E.g.*, 70 Fed. Reg. at 24,579. External audits evaluate the financial institution's financial statements, a core element of the proper functioning of the financial institution, and thus the element that has the closest nexus to traditional safety and soundness concerns. Contracts between accounting firms and financial institutions for non-audit services, on the other hand, are analogous to any contract with a professional service provider, such as a financial advisor.

audit arrangements that include" many common contractual provisions, would apply to provisions that do not implicate an accounting firm's independence.[2]

Auditor independence is already thoroughly regulated by entities who regularly monitor and enforce independence provisions. The Proposal recognizes that the SEC, the PCAOB, and the AICPA provide an extensive scheme of regulatory oversight for the actions of accounting firms in their various functions, including audit functions.[3] Those entities have developed a significant body of expertise and regulations regarding the actions accounting firms may take while maintaining their independence. For example, the AICPA has issued ethics rulings explaining that it is permissible for auditors to have alternative dispute resolution provisions and provisions indemnifying auditors for the knowing misrepresentations of management in their engagement letters.[4] Those entities, which deal with auditor independence issues on a day-to-day basis, are in an excellent position to evaluate potential pitfalls to auditing and to develop appropriately contoured regulations to permit auditors and audit clients to allocate risk, while preserving independence. Yet the Proposal goes far beyond the independence standards established by the SEC, PCAOB, and AICPA.[5] The Proposal thus runs the risk of contradicting or overtaking other aspects of audit regulation.

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2 70 Fed. Reg. at 24,578.

3 *Id.*

4 AICPA Ethics Ruling 95 (ET § 191.190-191); AICPA Ethics Ruling 94 (ET § 191.188-189).

5 The assertion that the Proposal complies with SEC guidance and AICPA standards, 70 Fed. Reg. at 24,579, is thus overstated.

The Proposal also does not mention the many other types of checks on an auditor's performance that lie outside the four corners of the engagement letter. Auditors remain subject to disciplinary action for acts or omissions during an audit, including license revocation, civil damages and fines, and criminal liability. In addition, auditors risk significant damage to their professional reputation and may lose business if they do not perform quality audits. All of these factors—regardless of the terms of the engagement letter—require auditors to exercise caution and diligence in performing their auditor work, and thus diminish the need for the proposed regulation.

B. Auditors Should Be Able To Manage Their Risks Contractually.

We also believe that the Proposal undermines basic notions of freedom of contract. Sophisticated commercial entities of equal bargaining strength are capable of negotiating to allocate the risk of economic loss inherent in any commercial transaction, and the allocation of risk agreed to by those parties should be respected.[6] As the Third Circuit has found, limitations provisions are "a way of allocating 'unknown or undeterminable risk,' and are a fact of every-day business and commercial life."[7] Assuming an agreement does not violate independence standards or other relevant auditing regulations, the Proposal does not demonstrate why an accounting firm and a financial institution should not be able to decide for themselves what is in their interests and enter into a contract memorializing their arrangement. Among other things, the sophisticated nature of the parties and the low likelihood that any given engagement will become the subject of litigation counsels strongly against a finding that provisions in

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6 *See Wisconsin Power & Light Co. v. Westinghouse Elec. Corp.*, 830 F.2d 1405, 1412 (7th Cir. 1987).

7 *Valhal Corp. v. Sullivan Assoc., Inc.,* 44 F.3d 195, 204 (3d Cir. 1995).

engagement letters, standing alone, raise safety and soundness concerns involving the nation's depository institutions.

Moreover, as the Proposal makes clear, a large majority of engagement letters do not contain *any* of the provisions identified in the Proposal.[8] This fact suggests that auditors and financial institutions are able to contract for these provisions freely, and have decided to use such provisions only in limited circumstances. As discussed below, a number of legitimate business reasons justify the use of such provisions in a variety of circumstances.

Entities such as financial institutions and accounting firms should be free to contract for predictability and efficiency in resolution of their disputes. The prohibitions contained in the Proposal will chill the bargaining process and have a detrimental effect on the free allocation of risk by the parties.[9]

C. Prohibiting Auditors From Managing Their Risks Contractually May Adversely Affect The Cost And Availability Of Auditing And Accounting Services.

1. The Cost Of Providing Auditing And Accounting Services May Rise If Firms Cannot Manage Their Risks.

By prohibiting provisions that allocate risk and casting doubt on alternative dispute resolution and waiver of jury trial, the Proposal may make auditing and accounting services more expensive and less accessible. The accounting profession and its clients are already burdened by

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8 70 Fed. Reg. at 24,578.

9 An essential part of freedom of contract, of course, is the value of executed agreements. In that regard, the suggestion in the Proposal that 2005 engagement letters may need to be re-formulated, would be particularly disruptive and unfair were it to be included in any final rule. 70 Fed. Reg. at 24,579. Indeed, such a purportedly retroactive change would raise difficult constitutional and other issues.

a massive increase in litigation.[10] Accounting firms consider these litigation risks in pricing their services, and even in determining which clients to accept.[11] *Requiring* auditors to assume more risk, may require them to seek additional compensation, in order to preserve an economic rationale for their contracts. Indeed, some audit firms may view potentially higher fees as inadequate to compensate for the compelled assumption of additional risk.

2. Fewer Audits May Be Performed If Contractual Terms Cannot Be Used To Manage Risk.

The Proposal may serve to reduce the number of accounting firms willing to provide audit services to the regulated entities. Excessive or unexpected risks can drive accounting firms away from certain practice areas or client groups, leading them to concentrate on more profitable areas of accounting with less litigation exposure. Financial institutions may be left with a smaller pool of accounting firms to choose from when seeking an auditor. In addition, because many of the financial entities regulated by the Council are not required to have audits performed, these entities may decide that the increased costs of retaining an accounting firm for voluntary

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10 *See, e.g.*, Terence W. McCormick, *'Red Flag' Claims Against Auditors In The Post-Enron World*, N.Y.L.J., Nov. 26, 2003, at p. 4 (noting that recent increases in litigation against auditors have "defied predictions"); John J. Rapisardi, *Second Circuit Decisions May Increase Accountant/Auditor Liability*, N.Y.L.J., Sept. 21, 2000, at Col. 1 (noting that "litigation costs for accountants continue to grow," especially because "accountants may be viewed as defendants with deep pockets").

11 *See* Robert Bruce, *Regulation Powers Rises In Fee Income*, FIN. TIMES at p. 2 (Feb. 28, 2005) (noting the willingness of firms to drop "clients they see as risky"); *Regulation And Unintended Consequences: Thoughts On Sarbanes-Oxley*, 74 CPA J. 6 (June 2004) (noting that, after the passage of the Sarbanes-Oxley Act of 2002, accounting firms are less likely to contract with clients that are perceived to pose unacceptable risks); Carl Pacini, Mary Martin & Lynda Hamilton, *At the Interface of Law and Accounting*, 37 AM. BUS. L.J. 171, 173 (2000) (noting that increased litigation has caused accounting firms to be "more aggressive in refusing to render services to high-litigation-risk firms").

audits are too great.[12] Thus, creating a mandate that parties may not contract to allocate risk may lead to higher audit costs, fewer service providers, and fewer financial institutions willing to engage in voluntary audits.

III. Specific Provisions

In order to assist the Council, we focus on five types of clauses in our specific comments below: alternative dispute resolution, waivers of jury trial, non-assignability provisions, indemnification clauses for the knowing misrepresentations of management, and punitive damages provisions.[13]

A. Alternative Dispute Resolution Provisions Are Common In Business Contracts And Strongly Supported By Federal Policy.

The Proposal is unclear as to the status of alternative dispute resolution provisions in engagement letters. The Proposal seems to claim that *all* alternative dispute mechanisms create safety and soundness concerns.[14] The Proposal also notes, however, that alternative dispute resolution provisions "may be efficient and cost-effective tools for resolving disputes in some cases."[15] Indeed, the use of many alternative dispute resolution mechanisms—such as mediation

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[12] 70 Fed. Reg. at 24,578.

[13] For the reasons given above, we also believe that the Council should not prohibit other provisions that are currently permissible under independence regulations.

[14] 70 Fed. Reg. at 24,577 ("Agreements by financial institutions . . . to submit to certain alternative dispute resolution (ADR) provisions that . . . limit the external auditors' liability may weaken the external auditors' objectivity, impartiality, and performance . . . . Therefore, such agreements raise safety and soundness concerns, and entering into such agreements is generally considered an unsafe and unsound practice.").

[15] *Id.* at 24,579.

and arbitration—does not mean that a party is giving up legal claims. The ambiguity in the Proposal regarding the status of alternative dispute resolution provisions would make it difficult for auditors and financial institutions to determine whether a given provision runs afoul of the Proposal.

The hostility evidenced toward such provisions in the Proposal also contravenes clear federal policy in favor of alternative dispute resolution. Federal policy encourages settlements of disputes outside of the court system. *See* Federal Arbitration Act, 9 U.S.C. § 1, *et seq.*; Alternative Dispute Resolution Act of 1998, Pub. L. No. 105-315, 112 Stat. 2993. Alternative dispute resolution mechanisms benefit *both* parties by providing for more efficient and less costly resolution of disputes. The AICPA has also specifically ruled that alternative dispute resolution provisions in engagement letters do not impair an auditor's independence.[16] The Proposal makes no showing as to how such a widely accepted practice, endorsed by federal policy, creates safety and soundness concerns.

B. <u>The Contractual Waiver Of The Right To A Jury Trial Poses No Threat To Auditor Independence.</u>

Pre-dispute jury waivers are a means by which parties can contain the costs and temper the unpredictability of a jury trial. Jury trials frequently take longer, cost more, are ill-suited to disputes involving complex business transactions or concepts, and pose a greater risk of disproportionate and unjustified awards of compensatory and punitive damages. Especially in complex commercial disputes, having a judge instead of a jury decide the matter brings

16 AICPA Ethics Ruling 95 (ET § 191.190-191).

significant advantages for both parties.[17] By using a judge, for example, "the uncertainty of a juror's whim" is eliminated, but the parties are still able to pursue "legitimate claims in a legal tribunal."[18]

The Proposal does acknowledge that jury trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. It cautions, however, that "financial institutions should take care to understand the ramifications" of agreeing to waive a jury trial before an audit dispute arises.[19] The Proposal warns further that, by waiving a jury trial, a financial institution "may effectively limit the amount it might receive in any settlement of its case."[20] But, in making that unsupported statement, the Proposal does not explain why *a judge or a professional arbitrator* would not award a financial institution the *true* value of its claim. All that both parties agree to avoid is the risk of an unexpected outcome from a jury, and the costs associated with jury trials.

The Proposal does not justify prohibiting the allocation of risk agreed to by sophisticated commercial entities. Indeed, any acceptance of alternative dispute resolution outside the court system necessarily entails the waiver of a right to jury trial, as arbitrators and mediators do not rely on jurors. The extensive use of alternative dispute resolution provisions in business contracts underscores that commercial entities are willing, as an evaluation of risk, to forgo the

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17 David T. Rusoff, *Contractual Jury Waivers*, 110 BANKING L.J. 4, 5 (1993).

18 *Id.* at 6-7.

19 70 Fed. Reg. at 24,579.

20 *Id.*

right to a jury trial to obtain other benefits. Sophisticated parties should be able to agree freely on provisions that require the waiver of a jury trial.

C. Provisions Limiting Assignment Or Transfer Of Claims Serve Legitimate Business Purposes.

The Proposal also would deem provisions prohibiting the assignment or transfer of claims against an external auditor to be an unsafe and unsound practice.[21] Such provisions, again, are common in commercial contracts and do not create an incentive for the external auditor to shirk its independence obligations regarding an audit. The law allows such provisions in a wide range of situations and external auditors and financial institutions have sound business reasons to include these types of provisions in engagement letters.

The ability to prohibit assignment or transfer of claims serves useful business purposes. Indeed, federal law presumes that *all* government contracts are non-assignable. The Anti-Assignment Act, 41 U.S.C. § 15, provides: "No contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned." Thus, the federal government itself embraces the notion of limiting assignments and transfers, as such is the default rule for public contracts.

Other provisions in the Anti-Assignment Act reinforce the notion that provisions limiting assignments and transfers are a sound and safe business practice. The Anti-Assignment Act has

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[21] The Proposal notes: "This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage." 70 Fed. Reg. at 24,580.

exceptions to the default rule explained above, including an exception for certain assignments of claims to "a bank, trust company, or other financial institution, including any Federal lending agency."[22] Even in those circumstances, however, the claim may not be assigned "if [the claim] arises under a contract which forbids such assignment."[23] In addition, when the government allows claims against it to be assigned, the assignor and assignee must meet several specific requirements that clarify the scope of the assignment.[24] Thus, the federal government recognizes the important value of using contractual obligations to limit the pool of potential claimants. These provisions, whose predecessors have been in the federal statutes for well over a century, were passed "in order that the government might not be harassed by multiplying the number of persons with whom it had to deal, and might always know with whom it was dealing."[25]

Many types of companies subject to strict regulation are allowed to include enforceable anti-assignment provisions in their contracts. Companies subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), for example, who act as fiduciaries for the participants and beneficiaries for the relevant ERISA plan, must act "*solely* in the interest of the participants

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[22] 41 U.S.C. § 15(b).

[23] *Id.* § 15(b)(1).

[24] 31 U.S.C. § 3727 ("An assignment may be made only after a claim is allowed, the amount of the claim is decided, and a warrant for payment of the claim has been issued. The assignment shall specify the warrant, must be made freely, and must be attested to by 2 witnesses. The person making the assignment shall acknowledge it before an official who may acknowledge a deed, and the official shall certify the assignment. The certificate shall state that the official completely explained the assignment when it was acknowledged.").

[25] *Hobbs v. McLean*, 117 U.S. 567, 576 (1886).

and beneficiaries," and must act with "care, skill, prudence, and diligence."[26] Even though ERISA fiduciaries must maintain these high standards with respect to their clients, they are allowed to include non-assignability provisions in contracts that provide benefits to participants and beneficiaries.[27] The ERISA fiduciaries may include these provisions even though an assignment to another entity "facilitates rather than hampers" the recovery of benefits.[28] The reason for allowing non-assignability provisions is simple: due to the contractual nature of an ERISA plan, "the parties are free to bargain for certain provisions in the plan—like assignability."[29] Allowing assignability does not affect the ERISA fiduciaries' obligations in providing benefits to plan participants, as they will be held liable to those participants should they violate their duties or the terms of the contract.[30]

External auditors have similar interests as the federal government and ERISA fiduciaries in seeking non-assignability provisions. For example, non-assignability provisions help external auditors to understand the scope of their risk by clarifying with whom they will be dealing, now and in the future. Non-assignability provisions can help external auditors avoid multiplying the number of persons with whom they have to deal and therefore lower their costs. The ability to

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[26] 29 U.S.C. § 1104(a)(1) (emphasis added).

[27] *City of Hope Nat'l Med. Ctr. v. Healthplus, Inc.*, 156 F.3d 223, 229 (1st Cir. 1998).

[28] *Id.* at 226.

[29] *Physicians Multispecialty Group v. Horton Homes, Inc.*, 371 F.3d 1291, 1296 (11th Cir. 2004).

[30] The Department of Labor has also issued an advisory opinion stating, among other things, that it would not preclude ERISA plans from including certain limitation of liability and indemnification clauses in service provider contracts. Dep't of Labor, Advisory Op. 2002-08A (Aug. 20, 2002).

include non-assignability provisions in certain engagement letters is no idle concern. For example, if management could commit audit-related fraud, and then assign the rights of the contract to another entity with arguably clean hands, the audit firm could be unfairly disadvantaged in any subsequent litigation over management's fraud.

External auditors have an obvious incentive to perform their work diligently and accurately because they can be sued by the entity with whom they have contracted. If the financial institution objects to a non-assignability provision, it can simply insist that the provision be removed during the negotiating process.[31] Creating a blanket rule against non-assignability provisions unnecessarily hamstrings external auditors and may discourage them from providing external audit services to certain financial institutions.

Any final rule should not state that the inclusion of a provision limiting assignability or transfer of claims constitutes an unsafe and unsound practice. Non-assignability provisions are a legitimate method for parties to clarify their risks without affecting their performance. External auditors and financial institutions should be able to negotiate whether a non-assignability provision is appropriate for their particular set of circumstances.

D. The FFIEC Should Await Further Guidance From The AICPA Regarding Indemnification Provisions For Knowing Misrepresentations Of Management.

Among the list of prohibited provisions in the Proposal is a provision that would indemnify the audit firm for claims attributable to any knowing misrepresentation by

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[31] As the Proposal notes, a non-assignability provision "may also prevent the financial institution from subrogating a claim" under its relevant insurance coverage. 70 Fed. Reg. at 24,580. Counsel for the financial institutions, however, are well aware of such possibilities and can bargain with the external auditor based upon their contractual position with other entities. That such negotiations to protect the financial institution's legal interests may occur, does not require a regulatory prohibition of non-assignability provisions in all circumstances.

management. We believe that the inclusion of such a provision in the Proposal is, at a minimum, premature at this point.

As noted by the Proposal, the SEC currently considers that such a provision creates an independence issue.[32] The SEC, however, does not regulate all engagement letters and audits that would be subject to the Proposal. As the Proposal acknowledges, under current law, credit unions and many non-public financial institutions are subject to rules that require their external auditors to comply only with the independence standards established by the AICPA.[33]

AICPA standards, unlike their SEC counterpart, specifically *allow* provisions indemnifying external auditors from claims attributable to the knowing misrepresentations of management.[34] Therefore, the longstanding view of the AICPA, upon which its members have relied for a number of years, is that such limited uses of indemnification clauses do not raise independence issues. If, for example, management has engaged in a knowing misrepresentation, it is extremely difficult for an external auditor to uncover the misrepresentation. Indeed, such an indemnification provision, in certain circumstances, may well prompt the management to be more forthcoming about their accounting practices and lead to a more effective audit.

Thus, the AICPA's view of the independence issues arising from such a limited indemnity provision is fundamentally reasonable. That the SEC has taken a different view of the same type of provision, in the very different context of SEC regulations, should not require that all financial institutions, even those not subject to SEC requirements, be excluded from the

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[32] 70 Fed. Reg. at 24,581.

[33] *Id.* at 24,578.

[34] AICPA Ethics Ruling 94 (ET § 191.188-189).

opportunity to use an indemnification provision covering the knowing misrepresentations of management.[35]

The Proposal correctly notes that the AICPA's Professional Ethics Executive Committee has established a task force to consider the broader issue of indemnification clauses in engagement letters. We understand that the FFIEC has participated in discussions with this task force. The Proposal, however, preempts any benefits of the task force's findings by simply declaring indemnification clauses in audit engagement letters to be unsafe and unsound business practices without considering the task force's report and conclusions. We suggest therefore, that at a minimum, the FFIEC await further guidance from the AICPA regarding indemnification clauses and independence issues.

E. Provisions Limiting The Award Of Punitive Damages Do Not Raise Safety And Soundness Concerns.

The Proposal also seeks to declare provisions that limit a party's ability to recover punitive damages to be unsafe and unsound.[36] We think that the Proposal misunderstands the nature of punitive damages. Punitive damages are designed—not to compensate—but to further distinct societal goals by punishing the offender. Indeed, by excluding provisions that limit

[35] SEC-regulated entities have other features, including the various corporate governance requirements of the Sarbanes-Oxley Act of 2002, that provide protections for auditors; those protections are not necessarily provided by all entities subject to regulation by the Council's members. Further, federal law makes it unlawful for officers and directors of SEC-regulated entities "to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading." Sarbanes-Oxley Act of 2002, § 303(a). As a result, SEC-regulated entities are subject to enhanced criminal liability for knowing misrepresentations to auditors. Thus, the difference in judgment between the SEC and the AICPA reflects an underlying reality about the legal requirements within which they regulate.

[36] 70 Fed. Reg. at 24,580.

punitive damages, the Proposal seems to mandate that, in all suits by regulated entities against their auditors, punitive damages be sought. Punitive damages have been repeatedly criticized by the courts.[37] Indeed, some states have placed limits on the availability of punitive damages in some circumstances, further underscoring that punitive damages are subject to legitimate concerns. Some foreign jurisdictions—where some of the parent organizations and holding companies of these financial institutions are domiciled—do not allow punitive damages at all. That regulated entities should be *entitled* to a windfall recovery through punitive damages stretches significantly the notion of safety and soundness; that they be required to seek such damages, as a matter of safety and soundness, seems plainly unjustified. Moreover, because punitive damages provisions are also the result of arms-length negotiations between sophisticated entities, we do not think these provisions raise safety and soundness concerns.

IV. Conclusion

Although we support efforts to protect safety and soundness, we believe that the Proposal, if adopted without substantial modification, will have dramatic, unintended, and adverse consequences. First, any final rule would be in addition to, and possibly inconsistent with, the existing independence requirements governing external audit engagement letters. Second, by prohibiting external audit arrangements that include certain risk-allocation terms, the Proposal would change the risk calculation with obvious financial consequences for all regulated entities. Third, the Proposal would impose significant new costs and burdens upon a myriad of transactions that are not problematic or controversial. Indeed, some perfectly appropriate

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37 *See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 417 (2003); *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 562 (1996).

transactions could be rendered uneconomical simply because the parties cannot bargain about risk. The nexus between these provisions and the Council's core "safety and soundness" concerns is remote.

The issues presented by the Proposal are very complex. We would be pleased to discuss the concerns expressed in this comment and to provide further thoughts as the FFIEC's deliberative process evolves. If you have any questions, please feel free to contact James L. Curry at (203) 761-3689.

Very truly yours,

Deloitte & Touche LLP

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