Practitioners often ask how they can protect their practices against liability claims. We are very pleased to share with members the following article by guest author David Wende. This article reflects the personal observations of David Wende based on his experience defending legacy CAs. This article is not to be construed or relied upon as legal advice by the reader. Practitioners are cautioned to seek their own independent legal advice as to how to best complete a client engagement where they seek any limitation of liability of a CPA practitioner or firm.

CPABC encourages members to consider the need to better protect themselves by using specific language in their engagement letters, but also reminds members of their professional obligations to consider clients' interests, recognizing that this is a delicate balance.

Members are reminded that the best practices offered by Mr. Wende below are for illustrative purposes only and do not reflect any official position of CPABC. Nor can CPABC, Mr. Wende, or his firm accept any liability whatsoever for any loss or damage, however caused, arising from the use of these suggestions. Members should incorporate Mr. Wende's suggestions to suit their needs and their clients' circumstances. It is up to the members' professional judgment in how they wish to use the recommendations offered by Mr. Wende and to consider seeking independent legal advice.

Best Practices for Limiting Liability by Using an Effective Engagement Letter

By David Wende

For many years prior to unification of the accounting profession, I shared with legacy CAs several sample engagement letters specifically designed to limit the liability of public accountants in the event of an error or omission. These engagement letters provided for:

- a fixed amount of damages in the event of a claim, which was defined to include all errors and omissions that might give rise to a lawsuit;
- a limited time period in which to bring an action against the public accountant [1];
- an exclusion of any claim against the individual members of the accounting firm such that only the firm itself could be named in any legal proceeding; and
- an acknowledgement that the public accountant could only be liable for her or his percentage or proportionate fault leading to the claim, thus preventing the accountant from serving as the insurer for other wrongdoers through joint liability.

Background

In 1993, the Supreme Court of Canada addressed the legitimacy of one party to a contract limiting the scope of its liability to the other party. In *Hunter Engineering Co. v. Syncrude Canada Ltd.* the Court held:

> *"Sophisticated parties can limit liability and contract out of limitation periods in **circumstances** that are not unconscionable, unfair, unreasonable or otherwise void for public policy".* [Emphasis added]

In 2010, the Supreme Court of Canada effectively confirmed the ability of parties to contractually exclude or limit their liability. In *Tercon Contractors Ltd. v. BC (Transportation and Highways*, 2010 SCC 4), the Court held that there was a three-part test to be undertaken by the Court in determining whether to uphold a clause excluding or limiting liability. The party seeking to enforce such a clause must: (1) establish that the exclusion clause applies to the circumstances of the plaintiff's claim; and (2) that the contract was not procured where there was unequal bargaining power or other circumstances that would make it unconscionable to enforce the clause. If the exclusion clause is otherwise enforceable, then: (3) the party seeking relief from the clause must persuade the court of

the existence of an overriding public policy that should prevent the clause from being enforced in the circumstances of the case. The Court cautioned that this overriding public policy must outweigh the very strong public interest in the enforcement of contracts.

Specific to CPAs, our Court of Appeal this fall in *Felty v. Ernst & Young LLP* 2015 BCCA 445 held that unlike lawyers, who are governed by the *Legal Profession Act* which prohibits lawyers from limiting their liability to clients, CPAs are free to do so given the absence of similar prohibitions in *the Chartered Professional Accountants Act*.

The *Felty* case demonstrates that the key to ensuring an engagement letter is enforceable is not just the content of the engagement letter, but the circumstances in which it is obtained. Let's address both.

Limitation of Liability Terms Should Be Fair and Reasonable

It's my experience that many CPA firms continue to limit liability to the amount of their fees. The recent *Felty* decision supports the enforceability of such clauses where it is clear that there is no element of "unconscionability" in the procurement of the signed engagement letter.

In *Felty*, E&Y conceded that its American affiliate had provided incorrect tax advice in a proposed divorce settlement that Ms. Felty alleged had cost her more than $500,000 in additional US taxes. This amount, and to what extent if any the Plaintiff had been damaged by the error, was very much in issue but did not have to be addressed. To the credit of its counsel, E&Y was able to successfully persuade both the Trial Judge and Court of Appeal to uphold its standard term limiting its liability to the amount of its fees ($15,000) for the specific tax advice negligently given. However, there were three factors that negated any suggestion of unequal bargaining power between accountant and client, or that the clause was obtained in circumstances that were unfair or unconscionable:

1. Ms. Felty had previously executed an earlier engagement letter with E&Y in which she had initially objected to E&Y's condition that its liability was to be limited to its fees, yet chose to proceed with the engagement on that basis;

2. The Trial Judge found that in executing both engagement letters, Ms Felty was under no personal compulsion because of any time restraints, and was free to approach and retain another accounting firm if she did not wish to accept the limitations of liability under the proposed E&Y engagements; and

3. Both engagement letters were executed with the independent legal advice of Ms. Felty's divorce lawyer. While certainly not a necessary component to ensuring the enforceability of the exclusion from any further liability, independent legal advice before entering into a contract virtually precludes any serious challenge of unequal bargaining power or "unconscionability" of the contract.

As a practitioner, what's important to your ability to enforce any limitation of liability clause is that you make your clients aware of its existence in your engagement letter, and that you give them the opportunity to either renegotiate with you, or find an alternate firm within a reasonable timeframe to meet their obligations or deadlines.

I have always recommended against limiting your liability to just your fees for a very practical reason: After 35 years of defending professionals, it's far easier in my experience to sell a contract to both the client and the courts as being fair and reasonable that provides for an agreed amount of compensation for a professional error, as opposed to an exclusion of any liability for the damages suffered by the client.

If there is what we call "a failure of consideration" in the performance by one party of its obligations under contract, then the wronged party is entitled in law to the return of what it paid the wrongdoer

under the bargain ***plus*** compensation for any damages suffered. Indeed, our Court of Appeal has clearly categorized such a clause as an "exclusion clause" because there is no element of compensation.

Our Courts have always been reluctant to enforce exclusion of liability clauses and will often exhaustively consider the circumstances in which the contract is obtained in an effort to find an exclusion clause was obtained in circumstances that were unconscionable to that fact pattern. In my experience, a professional who charges a significant hourly fee and then insists that his or her liability should not extend beyond returning its fees for an error or omission only invites a hostile reaction from both the client and our courts.

Recommended Limit

Instead, I recommend that the amount of damages be fixed within the engagement letter to provide for an agreed level of compensation that in most instances will be a multiple of the fees charged. The amount should be a function of both the level of assurance or reliance upon the CPA, and the amount that the client is paying for their services. More to the point, it's a much easier sell to any reluctant client than excluding all liability save the return of your fees.

I often recommend that a starting point for limiting liability should be no more than the lesser of five times the fees or a six figure limit. This is particularly true for tax planning, or other services unrelated to the financial statements of the client. A good starting point for a compilation of financial statements and T2 preparation is often $25,000; for a review, $50,000 and for an audit, $100,000. Note I said "starting point" - I will discuss further below. Rest assured, your insurer will still be overjoyed to have an enforceable engagement letter with such a modest limit of liability.

Limitation Period

The other term that must be carefully considered is the reduction of any limitation period in which the client may sue the accountant.

Commencing in 2013, the *Limitation Act* in British Columbia reduced the time in which clients may sue for professional negligence from six years to two years following "discovery" of the loss. The two-year period doesn't start until the claimant knows or ought reasonably to know:

- Injury, loss or damage has occurred;
- It was caused by an act or omission of the accountant; and
- Having regard to the nature of the injury, loss or damage, a court proceeding would be an appropriate means to seek a remedy.

The first two of the above requisites are usually easy enough to determine. However, it is the last, rather ambiguous, requisite that seems to have been deliberately intended by the British Columbia Legislature to permit the Courts considerable flexibility to extend the discovery period before the two year limitation in which to sue commences.

In my view, it is difficult to argue that a three year limitation period for all matters other than income tax is unfair, unreasonable, or unconscionable. A three year limitation period for tax matters is more likely to be struck down by the Courts, given that the client can be reassessed for up to three years following the initial Notice of Assessment. Hence, I recommend a minimum of four years for these professional services.

Obtaining the Client's Agreement

The decision in *Salgado v. Toth*, 2009 BCSC 1515 (CanLII) is a complete study in how to ensure that limitation of liability clauses ***will not*** be enforced by our Courts. In this case, Mr. Salgado and his partner retained Mr. Toth to undertake a home inspection prior to completing their offer to purchase what became their home. In return for his $450 fee, Mr. Toth provided his report just as the

time to remove the “subject to inspection” clause on the offer was to expire. At the same time, he required Mr. Salgado to sign his engagement letter which limited Mr. Toth’s liability to the amount of his fees. With little opportunity to read the contract or consider it, only Mr. Salgado signed it, whereupon he received the home inspection report that opined that no more than $20,000 in repairs was necessary to a home purchased for $1,095,000. Mr. Toth’s estimate of the amount necessary to repair deficiencies in the home was in error by approximately $200,000.

Mr. Justice Burnyeat had no difficulty in ruling that the limitation of liability provisions in Mr. Toth’s contract form was completely unenforceable based on the manner in which Mr. Salgado’s signature was obtained. If there are any lessons to be taken from this case as to how to render an engagement letter with limitations of liability ***unenforceable***, they are:

- Do not draw the limitation of liability language to the client’s attention;
- Do not give the client sufficient time to read and understand it;
- Deprive the client of the ability to negotiate, or any real choice, by providing your product just short of the client’s deadline to receive and deal with it; and
- Do not obtain the signature of your clients evidencing their agreement.

So how do you make your engagement letters as “iron clad” and enforceable as possible? Here are the policies that I suggest CPAs follow:

1. Forward the engagement letter to your client well in advance of your commencing the engagement. I recommend you use email – it provides clear evidence it was sent to the client in advance of the engagement, giving ample opportunity for it to be considered by the client. You do not need an original to be returned to you bearing the client’s signature. The *Electronic Transactions Act*, SBC 2001, c. 10 provides that where a signature is required under a contract, an electronic one is sufficient.

2. In the text of your email, advise the client that you require their signature agreeing to the terms and conditions before you can begin work. Ask the client to carefully review the engagement letter and, in particular, to note the mutual obligations each of you are assuming and the terms limiting your liability. Conclude your email with the request that if the client has any questions or concerns, to not hesitate to contact you before the signed contract is returned to you. Put a copy of this email in your engagement letter file and in your working papers.

3. The engagement letter itself should warn the client in the opening paragraph that this letter governs your respective contractual obligations and that it contains language limiting your liability. Place the text of the limitation of liability language under a clear, bold heading entitled “Limitation of Liability”. Conclude the paragraph or section that limits your liability to a specific amount with: “If this limit of liability is insufficient for your purposes, we would be pleased to discuss with you a different limit that may result in our charging a higher fee.”

4. Your engagement letter may contain a provision that the terms and conditions survive each annual engagement until modified by the parties. I recommend that you still obtain a new engagement letter every year. Nothing supports the argument of informed consent better than multiple engagement letters in which you have limited your liability.

5. Ensure that the engagement letter is broad enough to cover all of the professional services you might be asked to provide. It is wise to include a term that specifically confirms that any additional services provided by you are also subject to the same terms and conditions found in your engagement letter. Remember that an engagement letter to undertake a corporate review and T2 preparation provides no protection for the other services you might provide the owner manager(s) in their personal capacity, thus another letter is needed for those services.

and

6. Never begin substantive work for a client until you have a signed engagement letter in your hands. If the engagement letter is not yet in your file, remind the client that you cannot proceed further without that signed engagement letter.

Dealing with Client Concerns

The very best thing that can happen is for your client to contact you and raise concerns about the limitation of liability provisions. The most serious objections will always come from your lawyer clients. As noted above, lawyers are not permitted by the *Legal Profession Act* to limit their liability. This makes sense because their relationships with their clients go beyond professional services and are mandated by law as "fiduciary". Fiduciaries and trustees have never been permitted to limit their liability. Unfortunately, too many lawyers will think those prohibitions will also apply to you. For years, I have told my clients that if the lawyer objects, do as E&Y did with Ms. Felty, and invite him or her to find another capable CPA who will not seek similar limitations of liability in their contracts. Then wish the lawyer good luck in doing so.

Most clients will only raise a concern about the amount of your liability. This gives you the opportunity to candidly discuss with your client an amount that they would be prepared to accept as damages. Doing so before the engagement begins and while there is time for the client to look elsewhere for those same professional services almost eliminates the suggestion of "unconscionability" or unequal bargaining power between you. More importantly, providing a level of compensation negotiated between the parties establishes that the parties have contractually put their minds to, and agreed in advance upon the amount of compensation that was fair in the circumstances.

If $25,000 is not sufficient for a compilation engagement, perhaps you might agree to double it. If the $50,000 limit you proposed for your review engagement is insufficient, perhaps you should clarify the nature of a review and whether that is appropriate for your client's needs. After all, if the client believes that there may be a material misstatement(s) in its financial statements greater than $50,000, how are you to reach the opposite conclusion based only on review, analysis, and discussion with the owners or management? Nevertheless, again propose increasing the limit to a higher amount that reflects a multiple of the amount of your fees but that is far less that your limits of professional liability insurance.

Having had the opportunity to read the engagement letter without any time limitations compelling their consent, or contacting you and renegotiating a limitation of liability term before signing and returning the engagement letter to you, it will be very difficult indeed for a client to claim they did not accept a clear and unambiguous limitation of liability clause.

Footnotes:

1. Firms that also practice in Alberta should know that any attempt to reduce the limitation period in that province will be voided under the Alberta *Limitation Act*.

David Wende serves as Of Counsel to Gudmundseth Mickelson LLP and restricts his practice to Chartered Professional Accountants and professional regulatory matters. Since his call to the Bar in 1980, David has devoted himself to defending professionals and providing for their continuing education and risk management requirements. David is perhaps best known for his work within the CA community. In addition to defending CAs in our Courts and in professional discipline matters, David has provided many hours of continuing professional development and risk management for the legacy Institute of Chartered Accountants of BC and its members, and served as the Institute's counsel in multiple capacities.