FFIEC Program Coordinator
Interagency Advisory on the Unsafe
and Unsound Use of Limitation of
Liability Provisions and Certain
Alternative Dispute Resolution
Provisions in External Audit
Engagement Letters

Dear Sirs,

I am legal counsel for a community bank; however, I write as an individual, and my views do not necessarily reflect those of my employer.

I respectfully dissent from the perspective of the proposed Advisory, which is seemingly that, "the litigious 1980s were Candide's legal paradise and the free market efforts to reform the system are illogical." The proposed Advisory is unsound and unreasonable at every level I can conceive - moral, ethical, economic, jurisprudential, and philosophical.

Every document I draft for the bank attempts to avoid court resolution of disputes. Wildly inconsistent court adjudications, with unconscionable punitive judgments, are unarguably inconsistent with the best interests of our shareholders. Our uneconomic US legal system has not served society well, and banks - whose only inventory is the societal store of value - have suffered more than most. I perceive the proposed Advisory is a self-serving document proffered by the FDIC, merely to preserve jobs for its professional liability liquidation unit.

You solicit specific commentary:

1) The Advisory, as written, indicates that limitation of liability provisions are inappropriate for all financial external audits.

a) Is the scope appropriate? If not, to which financial institutions should the Advisory apply, and why?

No. One-size fits all has been a regulatory bane on the industry since the 1970s. Every time the regulators restrict the way banks do business, the costs of compliance fall disproportionately on small banks. Large banks are effectively too large to fail, and thus the regulators' potential suits against their external auditors are a mere theoretical possibility. Small banks are actually paid off in failure, and the litigious regulators always sue external auditors, even if there is no good faith case. Audit firms are not stupid; they know how regulators act. As a direct result of the regulatory practices, the audit firms limit the areas they will review and increase the amount they charge (to thus fund their malpractice insurance); neither of these effects produce a benefit for banks. Thus, all external audits cost small banks proportionately more than those expenses suffered by large banks, and every limitation by the regulators increases the expenses, and decreases the capital, of the beneficiary-bank.

Nevertheless, there are potential benefits from the annual external audits. In order to keep the benefit of those audits at an affordable price, we would be willing to waive malpractice claims entirely. Our goal is not to be able to sue our auditors, but to get the benefit of their perspective. If we think an auditor is incompetent, we want to fire them, not sue them. We believe the proposed Advisory foolishly adds unnecessary expense and restricts the scope of the auditors' analysis.

In a rational world, there would be no Advisory at all. The Advisory should apply only to those banks that are too large to fail.

b) Should the Advisory apply to financial institution audits that are not required by law, regulation, or order?

No. There is no measurable benefit from the proposed Advisory. Imposing the uneconomic Advisory on any audit is unsound.

2) What effects would the issuance of this Advisory have on financial institution's ability to negotiate the terms of audit engagement?

This year our bank will spend, on external accounting fees, an amount equal to 1% of our total capital. The proposed Advisory will only add to the expense, as we have numerous disclaimers in our accounting agreements. But for the regulator-imposed audit standards and requirements, we would be able to obtain benefit of auditor expertise for 25% of our current outlays.

3) Would the Advisory on limitation of liability provisions result in an increase in external audit fees? (I cannot believe you have to ask.)

(a) If yes, would the increase be significant?

Yes. We hire only economically-rational auditors. If we are compelled to delete all of the legal disclaimers, our expenses will rise markedly. We know, because we shopped our audit last year.

(b) Would it discourage financial institutions that voluntarily obtain audits from continuing to be audited?

I cannot speak for those 14 remaining institutions. Regulators, as a practical matter, have been requiring external audit for 25 years.

(c) Would it result in fewer audit firms being willing to provide external audit services to financial institutions?

No. Since the auditors know that they sell a required service, they hold a monopolist's control over their clientele. Bank expenses will rise, but that will not make any auditors unhappy.

4) The Advisory describes three general categories of limitation of liability provisions.

(a) Is the description complete and accurate?

No, the descriptions sound limited, but in fact deceptively conceal a broad list of innocuous activities that would be forbidden by the Advisory. Further, the use of the term "Advisory" deceptively hides the fact that these will be employed by the regulators as "unsafe and unsound activities" per se. That this Advisory will be used as an element of "cease and desist activities" suggests that this "Advisory" should be honestly published as a regulation, albeit one not sanctioned by law.

(b) Is there any aspect of the Advisory or terminology that needs clarification?

Yes, the section of law authorizing the regulators to impose these new requirements.

5) Appendix A of the Advisory contains examples of limitation of liability provisions.

(a) Do the examples clearly and sufficiently illustrate the types of provisions that are inappropriate?

I suspect the examples clearly illustrate the types of provisions that FDIC liquidators dislike. Each appears to me to be a perfectly reasonable and justifiable restriction.

(b) Are there other inappropriate limitation of liability provisions that should be included in the Advisory?

Since I think mandatory arbitration provisions are a good idea, I suppose that is one you forgot to include. I have one simple format I use regularly:

"The parties agree that any claim related to this contract shall be subject to binding Arbitration at the election of either party, costs to be divided equally. The Neutral shall set all terms of any Arbitration. If the parties are unable to agree on selection of a Neutral, the American Arbitration Association shall appoint a Neutral to adjudicate any dispute arising under this contract. In the event American Arbitration Association is unable or unwilling to act, Georgia Bar Association shall select a Neutral."

6) Is there a valid business purpose for financial institutions to agree to any limitation of liability provision? (Yes, in every case.) If so, please describe the limitation of liability provision and its business purpose.

"Release from Liability for Auditor Negligence" provision - merely waives simple negligence. Anyone can commit simple negligence - we suffer from negligence committed by the regulators at every examination, because people are not perfect. I have no problem holding auditors to the same standard we hold our employees. If someone screws up, we fire them; if the cause of the error is worse than simple negligence, we try to put them in jail. Auditors and regulators should be held to that same standard.

"No Damages" provision - simply says that auditors will be liable only for true damages arising from their actions. Lawyers can creatively manufacture damages with no true relation to the duty assume nor to the injury suffered, and these provisions are intended to foil that bad faith game played by litigators.

"Limitation of Period to File Claim" - this is a Trojan horse.

Malpractice is reasonably limited by statute everywhere to three years or less, so these clauses, where they exist, obtain no support from courts. I suppose these clauses may stop claimants from asserting phony non-malpractice tort claims.

"Losses Occurring During Periods Audited" provision - the regulatory objection is perverse. Why should auditors have liability for times and losses outside their audit scope? The commentary seemingly whines that this may preclude "tolling" of claims, but I think that misreads the history of the courts.

"No Assignment or Transfer" provision - as Deep Throat said, "Follow the money." Here we get to the crux of the Advisory - the regulators want to be able to manufacture suits against the auditors. If my bank can get the audit for half price with this provision, let us save the money. If the regulators want a right to sue, let them pay for it directly, and leave my bank out of the calculation. Why does the FDIC not simply re-insure its losses arising from accounting errors? That would be far cheaper than imposing these costs at the institution level.

"Knowing Misrepresentations by Management" provision - the Advisory thus manufactures the doctrine of "Respondeat Inferior" which has been rejected in every jurisdiction that has ever enjoyed an opportunity to consider it. The regulators need to sue the entity responsible for the evil, not the people trying to find it. The regulatory opposition to this provision is jurisprudentially abominable.

"Indemnification for Management Negligence" provision - this is the twin brother of the preceding clause, and merits the same explanation.

"Damages Not to Exceed Fees Paid" provision - we hire auditors to report, not to act as a surety. The regulatory opposition to this provision misapprehends the purpose of audit. In a follow "Note," the Advisory sarcastically criticizes "liquidated damages" provisions, which are an intelligent free-market solution to the issue of "incalculable" damages.

7) The Advisory strongly recommends that financial institutions take appropriate action to nullify limitation of liability provisions in 2005 audit engagement letters that have already been accepted. Is this recommendation appropriate? If not, please explain you rationale (including burden and cost).

It is not a matter of burden and cost, it is a matter of right and wrong. Ethical people who negotiate a deal in good faith do not reopen negotiations. If our regulators were honest, the auditors would have the same liability to banks as regulators. We anticipate that regulators would not willingly expose themselves to court liability for their torts against banks, and holding anyone else to a different standard is an equal moral wrong.

Summary

I would be delighted to meet with those who would impose this abomination on our industry.

Joel McLemore
(404) 653-2887