CORPORATE
ARBITRATION

Arbitration of audit disputes

Arbitration hasn't traditionally been used in audit-related disputes but its increasing use is an important opportunity for audit relationships globally

1 MINUTE READ

Arbitration has not traditionally been used to resolve disputes between external auditors and their clients. Yet, it is ideally suited to resolving audit disputes effectively and efficiently because it: (1) enables the parties to appoint reliable decision-makers; (2) is typically speedier and less expensive than litigation in the national courts; (3) gives parties the opportunity to resolve their dispute confidentially; and (4) mitigates risks of corruption and lack of judicial independence.

Tips and strategies are provided for crafting effective arbitration clauses that will help external auditors and their clients meet their dispute resolution needs around the world.

Companies around the world routinely are audited by external auditors. Independent auditing plays a critical role in the global capital markets, often mandated by law, and is a nearly ubiquitous practice in the modern economy. Audit clients generally contract with their external auditors through engagement letters. These contracts historically have not included arbitration clauses, even by parties that routinely utilise arbitration clauses for their other commercial agreements.

While the major audit firms in the US have started to regularly include arbitration agreements in their engagement letters over the past decade, this still is generally not the case outside of the US. Outside of the US, arbitration has rarely been used for resolution of audit disputes, leaving such disputes instead to the local courts. It is difficult to say why this is the case; it is more likely a product of tradition than a deliberate assessment that arbitration is not suitable to audit disputes or that local litigation is a more favorable dispute resolution option.

In fact, audit disputes are *precisely* the sort of complex commercial disputes that are ideally suited to arbitration. Arbitration would enable audit firms and their clients to realise all of the traditional benefits of arbitration that other commercial parties have reaped for decades. To begin with, arbitration would take audit disputes out of the courts. In most countries, this would significantly advantage both parties, since the courts of most countries are incapable of effective or efficient resolution of such disputes due to a combination of extensive litigation delays, lack of commercial experience, corruption, and/or a lack of judicial independence. As a former global general counsel at PricewaterhouseCoopers International, this author had the opportunity to experience audit-related litigation in dozens of countries. Based on that experience, it is his view that the courts of most countries around the world are poorly suited to adjudicating audit disputes in an effective, efficient and reliable manner, and that arbitration is a far better solution.

The time has come to recognise and promote the use of arbitration as a mechanism to more effectively and efficiently resolve audit-related disputes around the world.

An overview of audit-related disputes

To assess the suitability of arbitration for audit-related disputes, it is helpful first to understand what audit-related disputes look like. These involve many of the traditional elements of other garden-variety commercial disputes, both in terms of liability and damages issues.

In many cases, audit disputes arise in the wake of a restatement of a client's financial statements to correct for errors or misstatements, sometimes leading to significant losses by the client and/or third party claims. This, in turn, may lead to claims and defenses between the external auditor and the audit client over the root cause of the error or misstatement.

Claims asserted by a client against its external auditor may involve allegations of breach of contract, negligence, fraud and/or other related claims by the client. They also include arguments over whether the auditor complied with applicable accounting principles or auditing standards. Where the client has become insolvent, such claims may be brought by a liquidator, receiver or trustee that steps into the shoes of the audit client. Auditors, on the other hand, may assert defenses that the misstatements in the financial statements were caused by the client, including affirmative defenses such as contributory fault or invoking common law defenses such as the *in pari delicto* doctrine, which may preclude the client from recovering damages for losses stemming from the client's own wrongdoing.

Audit disputes look much like the types of disputes that have been commonly resolved through arbitration around the world for many decades. While particular expertise is often needed in these cases, the same can be said for many other categories of disputes. As explained below, the dynamics of audit disputes make them a prime candidate for resolution through arbitration around the world.

Why arbitration is ideally suited for audit disputes

Legal claims arising from auditor/client relationship often represent a significant risk both for the audit firm and the audit client, making it important for the claims to be resolved reliably, effectively and efficiently. Arbitration invariably will achieve these goals better than litigation of audit disputes in the national courts for at least four key reasons.

Reliable decision-makers Arbitration enables the parties to have the dispute resolved by a factfinder who grasps the complex issues of liability and damages that often arise in connection with audit disputes. Such cases often turn on complex financial and accounting issues or on an understanding of regulatory accounting and auditing standards. Judges and juries around the world are rarely familiar with the relevant financial, commercial, legal and regulatory standards that typically underlie such disputes. Even experienced judges rarely have the time to work through those issues due to congested dockets. Arbitration, on the other hand, enables parties to appoint arbitrators with specialised knowledge in the field, fostering a more informed and reliable decision-making process. Moreover, it is well known that courts in many parts of the world are subject to significant corruption risks and/or suffer from a lack of judicial independence that makes them especially subject to political influence and interference. Arbitration mitigates these risks by enabling parties to select arbitrators that they trust will resolve the dispute independently and impartially.

Speedier resolution As mentioned above, audit disputes often involve sensitive issues that need to be resolved expeditiously, enabling the parties to put the dispute behind them. Speedier resolution also helps to mitigate the significant management distraction that adjudicating audit disputes may entail. Arbitration provides a faster option than litigation in the national courts of most countries around the world. Litigation in many countries around the world is plagued by extensive delays, sometimes taking 10 years or longer to resolve. This is especially prevalent in developing countries. By contrast, international arbitrations generally are concluded within 12 to 18 months of initial filing and sometimes even faster.

Reduced cost Since arbitration is generally faster than litigation in the courts, it typically (but not always) follows that arbitration is less expensive than litigation. In the US, the cost of litigation often is driven by the cost of discovery, which can be difficult to control. To be sure, audit-related disputes typically require some form of discovery by both the audit client and the audit firm. For common law countries like the US where discovery is available in the courts, arbitration provides an opportunity to conduct discovery on a more streamlined and efficient basis, thus helping to reduce the overall cost of the process. For civil law countries where discovery is not available in the courts, international arbitration gives the parties the ability to obtain the documents and information that they need in a targeted fashion, thereby enabling a fairer and more reliable adjudication of the case. Frameworks like the International Bar Association's (IBA) Rules on the Taking of Evidence in International Arbitration provide an established and sensible discovery framework that also helps the parties to manage the costs of discovery.

Confidentiality As noted above, audit disputes often involve sensitive issues for both the audit firm and the audit client, such as the root cause of misstatements in the client's financial statements. Resolution of such issues in the courts often means having to air such sensitive issues in public, in some cases leading to significant reputational and market risk for both parties. Arbitration offers parties the opportunity to resolve their dispute confidentially. For instance, the CPR International Institute for Conflict Prevention & Resolution's Rules for Administered Arbitration of International Disputes (in rule 20) impose a presumptive confidentiality obligation on the parties, the tribunal and the institution with regard to 'the proceedings, any related disclosure and the decisions of the Tribunal'. Other institutions do not impose this confidentiality obligation but the parties are, of course, free to require confidentiality in their dispute resolution clause.

Key considerations in crafting an effective arbitration clause

Enforceability

It is likely that arbitration agreements in accounting engagement letters would be considered enforceable in most jurisdictions as US and UK courts have already held. Thus, there should not be major challenges to transitioning to arbitration for audit-related disputes. However, audit firms and companies should keep certain industry-specific considerations in mind to establish an arbitration framework that promotes maximum enforceability of arbitration clauses and arbitral awards.

There are generally three critical components of enforceability: (1) existence of a clause; (2) scope of the clause; and (3) arbitrability of the subject matter. The first

two can easily be addressed by designing a clause that provides for a broad scope of coverage. The benefits of a broad clause may include evidencing the parties' intent to extend arbitration to a broad range of disputes identified ex ante, and avoiding disputes down the road as to whether particular claims were meant to be included within the scope of the arbitration agreement.

A broad arbitration clause between the audit firm and audit client may also extend the arbitration agreement to cover certain third-party disputes. For instance, multiple decisions (in the United States at least) have enforced arbitration agreements in connection with class actions. Arbitration clauses in the US have also been held enforceable in derivative actions filed by shareholders.

Perhaps the most challenging issue in terms of clause enforceability will be the extent to which an arbitration agreement signed by the audit client would be enforceable against the client's successor in the event of an insolvency. Some US courts have been hesitant to compel arbitration against non-signatories in the liquidation context, especially where the claims asserted are not contractually based. Regardless of the jurisdiction, audit firms and clients will need to consider the extent to which their arbitration agreement would be enforceable against successors, and the extent to which this issue bears on the overall attractiveness of arbitration for them as a dispute resolution option.

Elements of the clause to be considered

In order to facilitate the establishment and implementation of an arbitration framework, firms and clients should consider the idiosyncrasies associated with disputes that regularly arise in the audit context and evaluate how to address best those in constructing their clause. Here are a few key elements to consider.

Choosing the right arbitral framework

As with any arbitration clause, the parties must choose whether they wish to utilise institutional arbitration or an ad hoc, non-administered arbitration framework. Given the complexities of most audit-related disputes, institutional arbitration is recommended given the value that institutional support can provide to the parties in helping them to achieve an efficient process.

In terms of choosing an arbitral institution, it is worth noting that internationally, there are no arbitration rules that are specially designed for audit-related disputes. However, in the case of audit disputes, special arbitral institutions or arbitration rules are not necessary. Audit-related disputes are essentially commercial disputes that international arbitration rules and institutions are already designed to handle.

In order to persuade audit firms and audit clients to arbitrate audit-related disputes in countries where arbitration has not been traditionally used in the audit space, the parties should utilise an institutional arbitration framework that is internationally recognised and locally accepted for significant commercial disputes, and vetted by audit-service consumers and providers. This will give parties the confidence that the arbitration framework they have chosen will be capable of effectively managing and resolving their dispute, no matter how complicated or sensitive.

Arbitrator qualifications

A key question for the parties to consider is whether the arbitrators should have special qualifications. For the resolution of audit disputes, accounting and auditing experience could, in some instances, be relevant, but it is generally not essential. In fact, in some instances, such qualifications could prove counterproductive as it creates the risk that the arbitrator may prejudge the matter based on past experiences. Moreover, including special qualifications in the arbitration clause will narrow the pool of arbitrators who are available to serve on the arbitral tribunal. Given the inevitable scheduling challenges and conflicts of interest that may disqualify potential candidates, narrowing the pool of candidates is a risk not be taken lightly.

To the extent that audit disputes require an understanding of specific auditing and accounting standards and regulatory requirements, or any other special qualifications, the parties can educate the tribunal through fact witnesses (especially audit team members) and experts (whether party-appointed or tribunal-appointed). All leading international arbitration rules provide for the presentation of such evidence.

In general, the most important qualities for a fair resolution of audit-related disputes are the same levels of commercial and legal experience that are necessary to resolve other types of commercial disputes, including the ability to understand financial statements and commercial governance concepts, prior experience as a judge or arbitrator in resolving complex commercial disputes, and, especially, a reputation for procedural and substantive fairness as well as a track record of capably applying legal and equitable concepts in arbitration.

> **Audit firms and clients have to consider the extent to which their arbitration agreement would be enforceable against successors**

Of course, even without any special qualifications in the arbitration clause, audit firms and clients are each free to appoint party-appointed arbitrators with special accounting or auditing experience if they so choose, or to include required arbitrator qualifications in their arbitration agreement. When the arbitral institution is called upon to appoint an arbitrator to the tribunal, such as the tribunal chair, the institution will also commonly take into account the nature of the dispute in determining whom to appoint.

Discovery

Document discovery is typically required in resolving audit disputes, both by the audit firm and the audit client. As a general matter, international arbitrations offer more limited discovery than in US litigation, but more substantial discovery than is available in civil law systemsAs a general matter, international arbitrations offer more limited discovery than in US litigation, but more substantial discovery than is available in civil law systems. The default scope of discovery in international arbitration is reflected in the IBA Rules on the Taking of Evidence in International Arbitration. While some tribunals do not

formally adopt the IBA Rules, they are often used as guidance. Under these rules, document discovery is permitted, but the parties are prohibited from engaging in fishing expeditions. Instead, documents requested must be specifically described, the requesting party must demonstrate why they believe the documents exist, and the documents must be 'material to the outcome of the case'. There is also no provision for deposition testimony or the use of interrogatories. Thus, the approach is obviously much more limited in scope than the framework of the US federal discovery rules.

In order to make the arbitration process more predictable, including the procedures governing discovery and presentation of evidence to the tribunal (the use of witness statements, evidentiary rules, privileges etc), parties can incorporate the IBA Rules into their arbitration clause, either as binding rules or as guidance. Doing so would provide greater certainty as to how the tribunal will conduct the proceedings.

The parties may also try to agree to specific discovery requirements in their clause, such as agreeing to automatic discovery of particular categories of documents (eg working papers). This is not recommended, however, because this can result in a one-sided burden on audit firms, without requiring any production by the client. Also, in some jurisdictions, it is not a foregone conclusion that the audit firm will be required to produce audit work papers. Moreover, it is difficult to predict at the time the engagement letter is formulated what documents will be needed to resolve hypothetical future disputes.

For all these reasons, this author recommends incorporating the IBA Rules into the arbitration clause, either as binding rules or as guidance, to afford the parties some parameters around discovery and presentation of evidence. It is preferable, however, not to predetermine the specific scope of written discovery, and rather to leave such matters to the parties and the tribunal once the claims and issues are known.

Expedited procedures

International arbitrations generally utilise default timetables set out in the arbitration rules selected. Most rules give arbitral tribunals a fair amount of flexibility, but commonly require them to issue an award within four to six months following the final hearing. In general, international arbitrations are completed, from commencement to final award, within 14 to 18 months. For disputes involving smaller damages claims, institutions offer expedited arbitration procedures that result in final awards within approximately six months of filing. Such expedited procedures are not, however, well suited to audit-related disputes, which often involve complex liability and damages issues and require expert testimony. It's recommended generally not to commit in an arbitration agreement to expedited arbitration for audit disputes. It should also be noted that even with a standard timetable, international arbitrations are still far quicker than judicial litigation processes in most countries.

Confidentiality clauses

Most institutions do not impose confidentiality obligations on the parties with regard to the arbitration proceedings; only personnel of the arbitral institution itself are subject to confidentiality obligations. Thus, absent an express confidentiality requirement agreed to by the parties in the arbitration clause or imposed by the tribunal, the parties may be free to publicly disclose information related to the arbitration proceedings.

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Due to the often-sensitive nature of audit disputes, both for the audit firm and the audit client, it may be desirable in an arbitration agreement to establish confidentiality obligations on the parties, subject to the requirements of law.

Use of tiered dispute resolution clauses

Many arbitral institutions offer mediation and early neutral evaluation services. Such mechanisms generally entail some preliminary exchange of documents and early disclosure of each side's positions and arguments. But doing so may lead to early resolution, especially in circumstances where clients do not understand the role of the auditor or what work the auditor performed during the course of the audit.

Tiered dispute-resolution procedures in the parties' agreement should be included, starting with executive consultation and/or mediation, before reaching the arbitration phase. It is important, however, that each phase of the dispute-resolution process include a pre-defined time line, to prevent one party from hijacking the dispute-resolution process under the guise of continued negotiating. Of course, even after a particular dispute-resolution phase has expired, the parties are free to continue with that phase if both agree.

Putting in perspective

Arbitration is ideally suited to the resolution of audit-related disputes. Like most other contractual relationships, parties in the auditor-client relationship stand to benefit significantly from adopting arbitration as the means of dispute resolution in order to achieve a more reliable and expeditious dispute resolution process, regardless of where the parties are located. These benefits are particularly apparent when one considers how audit-related litigation is conducted in the national courts of most countries. The flexibility of arbitration gives audit firms and clients the ability to craft a dispute resolution process that will meet their particular needs.

While arbitration has not historically been used to resolve audit-related disputes around the world, the expanded use of arbitration for audit engagements in the US provides an opportunity to promote the use of arbitration for audit disputes globally, particularly given that commercial parties around the world already are commonly using arbitration to resolve their other commercial disputes. The time has come to get the word out.

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