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SUPREME COURT OF KENTUCKY
2007-SC-000770-T & 2007-SC-000936-T

ON APPEAL FROM FRANKLIN CIRCUIT COURT
CASE NOS. 05-CI-00455 & 05-CI-00344
AND ON REVIEW FROM COURT OF APPEALS
NOS. 2007-CA-002050 & 2007-CA-002525

ERNST & YOUNG LLP, ET AL.	**APPELLANTS**
v.	
SHARON P. CLARK, IN HER OFFICIAL CAPACITY AS COMMISSIONER FOR THE KENTUCKY DEPARTMENT OF INSURANCE AND REHABILITATOR OF AIK COMP	**APPELLEES**

AND

ERNST & YOUNG LLP	**APPELLANT**
v.	
APPALACHIAN REGIONAL HEALTHCARE, INC., ET AL.	**APPELLEES**

REPLY BRIEF FOR APPELLANTS ERNST & YOUNG LLP & DAVID S. MEYER TO APPALACHIAN PLAINTIFFS

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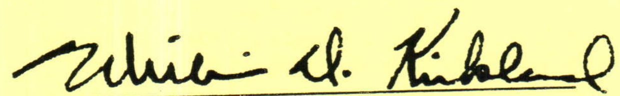

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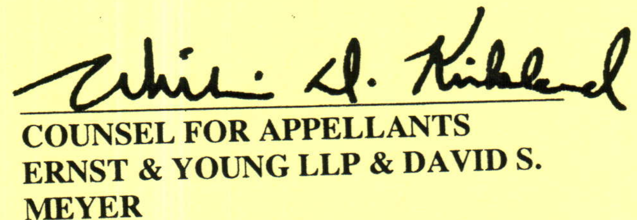
CERTIFICATE OF SERVICE REQUIRED BY CR 76.12(6)

I hereby certify that on this 26th day of September, 2008, true and correct copies of this Reply Brief have been served by first class mail upon Sally Jump, Clerk, Franklin Circuit Court, Courthouse, 214 St. Clair Street, P.O. Box 678, Frankfort, Kentucky 40602; the Honorable Thomas D. Wingate, Franklin Circuit Court Judge, Courthouse, 214 St. Clair St., P.O. Box 378, Frankfort, Kentucky 40602; Samuel Givens, Jr., Clerk, Kentucky Court of Appeals, 360 Democrat Drive, Frankfort, Kentucky 40601; Walter L. Sales, Stoll Keenon Ogden PLLC, 2000 PNC Plaza, 500 West Jefferson Street, Louisville, Kentucky 40202; Paul C. Harnice, Stoll Keenon Ogden PLLC, 307 Washington Street, Frankfort, Kentucky 40601; Perry M. Bentley, Stoll Keenon Ogden PLLC, 300 West Vine Street, Suite 2100, Lexington, Kentucky 40507-1801; Bernard F. Lovely, Jr., Bowles Rice McDavid Graff & Love, LLP, Suite 1700, 333 West Vine Street, Lexington, Kentucky 40507-1639; J. Guthrie True, Johnson, True & Guarnieri, 326 West Main Street, Frankfort, Kentucky 40601; David C. Olson, Frost Brown Todd LLC, 2200 PNC Center, 201 East Fifth Street, Cincinnati, Ohio 45202; Robert J. D'Anniballe, Jr., Pietragallo, Bosick & Gordon, LLP, 100 North Fourth Street, 10th Floor, Steubenville, Ohio 43952; Gary Weiss, Weiss & Cobb, 9420 Bunsen Parkway, Suite 306, Louisville, Kentucky 40220; Barbara B. Edelman, Dinsmore & Shohl LLP, 250 West Main Street, Suite 1400, Lexington, Kentucky 40507; Ronald R. Parry, Parry Deering Futscher & Sparks, PSC, 411 Garrard Street, P.O. Box 2618, Covington, Kentucky 41012-2618; Charles D. Greenwell, Goldberg Simpson LLC, 9301 Dayflower Street, Louisville, Kentucky 40059; Charles G. Middleton, III, Middleton & Reutlinger, 2500 Brown & Williamson Tower, Louisville, Kentucky 40202; Terry Goodman, Waite, Schneider, Bayless & Chesley, Suite 1513, Central Trust Tower, Cincinnati, Ohio 45202; Robert W. Bishop, 6520 Glenridge Park, Suite 6, Louisville, Kentucky 40222; Walter M. Jones, Wyatt Tarrant & Combs, 500 West Jefferson Street, Suite 2600, Louisville, Kentucky 40202; Kathleen Kearney Schell, 422 E. 7th Street, Jeffersonville, Indiana 47130-3818; Stewart C. Burch, Logan & Gaines, PLLC, 114 West Clinton Street, Frankfort, Kentucky 40601; Todd C. Meyers, Bowles Rice McDavid Graff & Love, LLP, 333 West Vine Street, Suite 1700, Lexington, Kentucky 40507-1639; John C. Hanley, Valenti Hanley & Crooks, Suite 1950, 401 West Main Street, Louisville, Kentucky 40202; David Tachau, Tachau Meek, 2400 National City Tower, 101 South Fifth Street, Louisville, Kentucky 40202; Jonathan D. Goldberg, Goldberg & Simpson, P.O. Box 221529, Louisville, Kentucky 40252-1529; John K. Schoen, Sales Tillman Wallbaum Catlett & Satterley, 325 West Main Street, Suite 1900, Louisville, Kentucky 40202; and Greg E. Mitchell, Frost Brown Todd, LLC, 2700 Lexington Financial Center, 250 West Main Street, Lexington, Kentucky 40507.



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INTRODUCTION

Ernst & Young LLP ("E&Y") and David Meyer hereby reply to the brief of the putative Class ("Class Br.") in further support of reversal of the erroneous decision below. Our opening brief ("Br.") demonstrated that Plaintiffs – allegedly E&Y's "actual clients" on the audit engagements at issue – are bound by the mandatory arbitration provisions of the Engagement Letters and, further, that Plaintiffs' claims fit comfortably within the scope of what is arbitrable. Plaintiffs resist on every front, but their brief, like the decision below, is multiply flawed. Indeed, only by rewriting the arbitration clause, disavowing key allegations in their own complaint, and ignoring Supreme Court precedent, can Plaintiffs assert that this case is not arbitrable. Such tactics cannot carry the day, so arbitration must follow.

I. PLAINTIFFS CANNOT DISAVOW THEIR OWN AGREEMENTS AND ALLEGATIONS TO ESCAPE ARBITRATION

A. Plaintiffs Admit The Agency Relationship That Binds Them

Any doubt about Plaintiffs' duty to arbitrate is erased by this passage in the Class brief:

> Plaintiffs, however, are *not* claiming Ernst & Young fraudulently induced Mr. Turner to enter into the Engagement Letters or that Mr. Turner exceeded his authority by doing so. (A203). Plaintiffs *concede* that Mr. Turner had the authority to retain an auditor such as Ernst & Young. . . . There are no allegations or claims in this case that the Engagement Letters were fraudulently induced by either Ernst & Young or Mr. Turner. *Id.*

(Class Br. 12.) When coupled with the indisputable agency relationship between CEO Turner and the putative Class, these concessions commit Plaintiffs to arbitration as surely as if they had signed the Engagement Letters themselves.

Several points are advanced in opposition, but none has merit. First, it is argued that the arbitration clause in the Engagement Letters for the years 1999 through 2001 "clearly excludes" Appellees, as compared to the arbitration clause for 2002, which presumably "clearly includes" them. (Class Br. 9-10.) This argument is based on a phrase in the 2002 arbitration clause that is absent in the clause for the prior years; this phrase references "(...any person or entity for whose benefit the services in question are or were provided)." But as explained in our opening brief (at 32-33), this phrase, preceded by the word "including[,]" is not one of limitation but instead language that simply identifies examples of claims that are arbitrable. "Include" means "to place, list or rate as a part or component of a whole or of a larger group, class, or aggregate." WEBSTER'S THIRD NEW INT'L DICTIONARY 1143 (17th ed. 1993). Further, Plaintiffs offer no rebuttal to the well established rule that principals can be bound under agency principles even if undisclosed. *See Coles v. Johns*, 377 S.W.2d 587, 589 (Ky. 1964).

If there is ambiguity in the clauses, then that is an issue for an arbitration panel to decide under a presumption of arbitrability. *See Louisville Peterbilt, Inc. v. Cox*, 132 S.W.3d 850, 855 (Ky. 2004); *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983). Because any ambiguity in this instance would rest in the arbitration provisions themselves, Plaintiffs' maxim construing contract ambiguities against the drafter (Class Br. 10) does not apply. *See Security Watch, Inc. v. Sentinel Sys., Inc.*, 176 F.3d 369, 374 (6th Cir. 1999).

Plaintiffs greatly overreach in arguing that because their claims cannot be separated by audit year, this entire matter is non-arbitrable. (Class Br. 10-11.) No support is cited save *Security Watch*, which is inapposite because that case involved

breach of warranty claims covering identifiable products sold under different contracts, only one of which included an arbitration clause. 176 F.3d at 372-73. The court reached the natural conclusion that with the claims so demarcated, there was no basis for extending an arbitration obligation in one year to prior year contracts that lacked the clause. *Id.* By contrast, Plaintiffs here insist that their claims cannot be segregated by year, and no authority justifies depriving E&Y of arbitration rights that plainly apply to at least a piece of this case. Under the Engagement Letters, "[a]ny issue concerning the extent to which any dispute is subject to arbitration . . . shall be governed by the [FAA] and resolved by the arbitrators." (*See* A290.) Where, as here, a written agreement expressly provides for arbitrating questions of arbitrability, the question must be decided in arbitration, and "a court must defer to an arbitrator's arbitrability decision." *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 943 (1995).

Perhaps recognizing this, Plaintiffs attempt to withdraw the crucial concessions above, arguing that Mr. Turner acted outside the scope of his authority. (Class Br. 11-12.) Supposedly, Plaintiffs can evade arbitration by merely *alleging* that Turner "breached his duties and obligations by misrepresenting the financial solvency and integrity of the Fund and thus acted outside the scope of any professed agency relationship." (*Id.* at 11.) This is nonsense given Plaintiffs' admission that the retention of E&Y and agreement to arbitrate *were* within the scope of Turner's authority (Class Br. 12), especially in light of state law requiring AIK Comp to file annual financial statements and to have those statements audited by an independent certified public accountant. *See* KRS §§ 304.50-060(4), 304.50-110(1). These allegations of wrongdoing are a sideshow, unrelated to contract formation generally, to the arbitration

obligation specifically, and, therefore, to arbitrability. Additionally, under an unbroken line of Supreme Court cases, any claim that Mr. Turner lacked authority to bind the putative Class challenges the Engagement Letters as a whole, not merely their arbitration provisions, and accordingly would be an issue for the arbitrators. (*See* Br. 36.)

Plaintiffs' arguments peter out with the contention that the agency relationship was limited to matters regarding the Kentucky Workers' Compensation Statutes, which do not encompass all of the complaint's claims. (Class Br. 12.) Ironically, the Class brief also urges – erroneously – that these same alleged statutory violations pose *obstacles* to arbitration. (*Id.* at 23.) The inconsistency matters not, for the agency had deeper roots and swept more broadly: as a condition of membership in AIK Comp, each member agreed to "conform to the terms of the agreements [AIK Comp] may enter into with any authorized service company." (Aff. of David S. Meyer dated July 11, 2007, Ex. A (A284).) E&Y was an authorized service provider to AIK Comp (Class Br. 12) under contracts imposing a duty to arbitrate.

B. Plaintiffs Are Bound As Third-Party Beneficiaries

By itself, the agency relationship discussed above is sufficient to bind Plaintiffs to arbitrate. However, E&Y has also demonstrated that Plaintiffs are bound as third-party beneficiaries whose claims arise from their status as such, and, thus, Plaintiffs are required to arbitrate. (Br. 36-38.) In response, Plaintiffs reprise their argument based on the language of the arbitration clauses in different years, even as they acknowledge their third-party beneficiary status under the 2002 Engagement Letter. (Class Br. 13.) But, creation of third-party rights does not require an intended beneficiary to be

identified when a contract is made. RESTATEMENT (SECOND) OF CONTRACTS § 308 (1981).

The decision in *Comer v. Micor, Inc.*, 436 F.3d 1098, 1102 (9th Cir. 2006), cited for the proposition that a third-party beneficiary cannot be bound to a contract it did not sign or assent to (Class Br. 13), does not help Plaintiffs. Unlike Mr. Comer, Plaintiffs assented to the contracts by agreeing to conform to the terms of agreements entered into by AIK. Unlike Mr. Comer, who asserted only a free-standing statutory claim, Plaintiffs have leveraged the contracts in this lawsuit. Having pled that they were E&Y's "actual clients" in connection with the audits of AIK Comp, Plaintiffs cannot now be heard to deny that they were the third-party beneficiaries of the agreements by which E&Y agreed to conduct those audits. Given that all of the claims are based on complaints about that audit work, Plaintiffs also cannot be heard to argue that their complaints do not arise out of their status as E&Y's "actual clients." These key points distinguish this case from the authorities cited at pages 13 through 17 of the Class Brief.

C. Equitable Estoppel Binds Plaintiffs

In addition to agency and third party beneficiary principles, E&Y's opening brief (at 38-40) established that the putative Class is also bound to arbitrate under principles of equitable estoppel because Plaintiffs cannot simultaneously sue for alleged audit malpractice and repudiate the provisions of the Engagement Letters pursuant to which E&Y agreed to conduct the audits. Appellees argue that equitable estoppel is inapplicable because (1) the doctrine does not apply unless plaintiffs seek to derive a direct benefit from the contract, and (2) they deny seeking or enjoying any "direct benefit" because AIK's financial statements proved inaccurate. (Class Br. 18-21.)

Plaintiffs again ignore their complaint. Plaintiffs, in fact, seek to derive a direct benefit from the Engagement Letters by claiming to be E&Y's "actual clients" (A. Compl. ¶ 185 (A242)) and by suing for failure to properly perform the services provided for in the contract. This is more than sufficient to preclude them from simultaneously reneging on contractual obligations. *See Sunkist Soft Drinks, Inc. v. Sunkist Growers, Inc.*, 10 F.3d 753, 757 (11th Cir. 1993) (applying equitable estoppel where claims were "intimately founded in and intertwined with the underlying contract obligations"); *McBro Planning & Dev. Co. v. Triangle Elec. Constr. Co.*, 741 F.2d 342, 344 (11th Cir. 1984) (same).

Plaintiffs insist (Class Br. 21) that they do not "allege that Ernst & Young failed to perform its duties set forth in its Engagement Letters, but rather that Ernst & Young engaged in conduct beyond the scope of its employment with AIK Comp[.]" This is absurd. Plaintiffs *are* complaining about the quality of E&Y's audits, which were performed pursuant to the Engagement Letters. (*See* Br. 31-32.) There is no serious allegation that E&Y provided any services or committed any act "beyond the scope."[1]

Plaintiffs' authorities are distinguishable. In *Thomson-CSF, S.A. v. American Arbitration Ass'n*, 64 F.3d 773, 779 (2d Cir. 1995), the court declined to apply equitable estoppel because the claim was not "integrally related to" the contract; here Plaintiffs' claims arise directly from services rendered pursuant to the Engagement Letters. In *Comer,* equitable estoppel did not apply because plaintiff based his lawsuit "entirely on

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[1] Scrambling to fill this hole, Appellees repeatedly assert that E&Y "prepared" AIK Comp's financial statements. (Class Br. 2-3.) This statement is false. E&Y *audited* the financial statements of AIK Comp, which were prepared by and are the responsibility of the management of AIK Comp. (*See* Second Aff. of David S. Meyer dated January 20, 2006, Exs. A-D (A99-110)).

ERISA, and not on the investment management agreements," 436 F.3d at 1102; this case, obviously, is different. In *NAMA Holdings, LLC v. Related World Market Center, LLC*, 922 A.2d 417, 432-33 (Del. Ch. 2007), the court reasoned that the plaintiff's benefits under the contract were incidental; benefits received by "actual clients" are direct. In *Graham v. Smith*, 292 F. Supp. 2d 153, 158 (D. Me. 2003), the court stressed that plaintiffs did "not assert claims that derive from contracts they did not sign[;]" here the opposite is true. The rejection of estoppel in *InterGen N.V. v. Grina*, 344 F.3d 134, 145 (1st Cir. 2003), turned substantially on an amended complaint that disavowed plaintiff's rights under the contract; here such rights are wielded as a sword.

Finally, there is no support for the lower court's conclusion that Plaintiffs could not have directly benefited from E&Y's services because any premium savings "have certainly been absorbed" by the penalties and assessments imposed by the Rehabilitator. (A. Order at 7 (A18).) Plaintiffs respond that the putative Class incurred liabilities in excess of $90 million (Class Br. 19 n.6), but as they surely recognize, this represents only half of the equation: E&Y does not deny that there were substantial assessments and penalties, but very much disputes that they more than offset Plaintiff's savings from lower premiums. Denial of arbitration on this ground in the absence of a trial or hearing cannot be sustained. (*See* Br. 39-40.)

II. PLAINTIFFS CANNOT REWRITE THE ARBITRATION CLAUSES TO EXCLUDE THEIR CLAIMS THAT PLAINLY FALL WITHIN THEM

Any fair reading of the arbitration clauses leads straight to the conclusion that Plaintiffs' claims are arbitrable. (*See* Br. 31-32.) The clauses require the arbitration of "[a]ny controversy or claim arising out of or relating to the *services* covered by" the Engagement Letters or subsequently provided by E&Y to AIK Comp. (A285-300

(emphasis added).) Each and every one of the claims fits this description because each is based on the allegation that, as a result of E&Y's alleged failure adequately to audit AIK Comp's financial statements, the statements were "false and deceptive." (*See* Br. 31-33.) However labeled, and whether based on common law or statutory grounds, these claims must be arbitrated. (*See id* at 34.)

With no answer to these controlling points, Appellees ignore them. Following in the footsteps of the court below, Plaintiffs instead seek to rewrite the arbitration clauses, arguing that there is no obligation to arbitrate because the claims "do not 'arise out of or relate to' the Engagement Letters[.]" (Class Br. 21.) Certainly these claims must at least "relate to" the Engagement Letters pursuant to which the audit services were provided. But that aside, this argument is misdirected because claims need only relate to E&Y's "services" to be arbitrable, a connection the complaint establishes beyond any possible doubt. (A223-24, A230, A237-40, A242.)

Plaintiffs' cases again are wide of the mark. Appellees place heavy reliance on *Boedecker v. Rogers*, 736 N.E.2d 955 (Ohio Ct. App. 1999), where the court denied arbitration in a derivative action against a corporate official. (Class Br. 21-23.) But the arbitration clause in that suit, included in an employment agreement between the official and his company, provided for arbitration "in the event of a [dispute] as to the conditions of performance" of the employment contract. *Boedecker*, 736 N.E.2d at 956. The court sensibly concluded that a derivative complaint raising myriad claims of misconduct, including fraud and breach of fiduciary duty, went beyond mere "conditions of performance." *Id.* at 958. In this case, the arbitration trigger is "services," and that trigger was pulled with Plaintiffs' filing of a complaint in which all

claims flow from the allegedly defective performance of "services." Whether those claims sound in breach of contract or tort or plead a statutory violation is irrelevant. (*See* Br. 34.)

Plaintiffs' reliance (Class Br. 23-24) on *Industrial Electronics Corp. of Wisconsin v. iPower Distribution Group, Inc.*, 215 F.3d 677 (7th Cir. 2000), fares no better. There the Seventh Circuit acknowledged that fraud claims arising out of contractual obligations *are* arbitrable, but declined to order arbitration because the alleged fraud grew out of a contract *other* than the one that contained the arbitration clauses. *Id.* at 681. Here the fraud claims are covered by contracts that all require arbitration.

III. EFFICIENCY CONSIDERATIONS CANNOT TRUMP THE FEDERAL MANDATE TO ARBITRATE

In the teeth of Supreme Court cases rejecting it, Plaintiffs double down on the Circuit Court's erroneous conclusion that "Inefficiencies Prevent Arbitration" (A18-19). (Class Br. 7-8, 24-27.) Citing the complexity of this case and its relationship to the Rehabilitator's case, Appellees proclaim that "[e]xpeditiously and predictably rehabilitating insolvent insurers is a 'compelling reason' to render ineffective any alleged contractual arbitration requirement." (Class Br. 26.)

Like the court below (*see* A18-19), Plaintiffs fail to cite any law to support this position – not surprising given the Supreme Court's enforcement of arbitration "even where the result would be the possibly inefficient maintenance of separate proceedings in different forums." *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 217 (1985). "[F]ederal law *requires* piecemeal resolution when necessary to give effect to an arbitration agreement[.]" *Id.* at 221 (citation omitted) (emphasis in original). Courts

may "not substitute [their] own views" for those of Congress. *Id.* at 217 (internal quotation and citation omitted).

The multi-party nature of this litigation and the pending Rehabilitator case change none of this:

> Under the Arbitration Act, an arbitration agreement must be enforced notwithstanding the presence of other persons who are parties to the underlying dispute but not to the arbitration agreement. If the dispute between Mercury and the Hospital *is* arbitrable under the Act, then the Hospital's two disputes will be resolved separately – one in arbitration, and the other (if at all) in state-court litigation.

Moses H. Cone Mem'l Hosp., 460 U.S. at 20 (footnote omitted) (emphasis in original).

So too here: even if this Court were to conclude that the Rehabilitator may carry on in the court below, "efficiency" would provide no license to ignore Plaintiffs' demonstrated obligation to arbitrate.

September 26, 2008

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