Hogan Lovells

Global Accountants' Liability Update

February 2018

Contents


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for a changing world

Welcome

Hogan Lovells' global team of securities and professional liability lawyers is uniquely positioned to monitor legal developments across the globe that impact accountants' liability risk. We have experienced lawyers on five continents ready to meet the complex needs of today's largest accounting firms as they navigate the extensive rules, regulations, and case law that shape their profession. During December 2017 and January 2018 we identified developments of interest in Italy, Mexico, The Netherlands, Spain, and The United States, which are summarized in the pages that follow.

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Recent Court Decisions

Mexico

Admonitions issued by the National Banking and Securities Commission to Certified Public Accountants may be challenged before the Federal Administrative Court.

Banking Law provides that the National Banking and Securities Commission (CNBV) may impose an admonition on a Certified Public Accountant (CPA) who allegedly failed to comply with the law and its regulations.

Such admonition may be challenged by filing an internal appeal before the CNBV or an annulment suit before the Administrative Court. In a recent case in which we were involved, a CPA filed an annulment suit before the Administrative Court challenging the lawfulness of an admonition.

Initially, the Administrative Court dismissed the lawsuit reasoning that: (i) it was not legally competent to analyze the case because the Internal Regulations of the Administrative Court do not consider admonitions a sanction that may be challenged before the Court; and (ii) an admonition is not a definitive ruling for the CPA because, in the view of the Court, it is only a warning that the CPA's behavior does not comply with law.

The CPA appealed urging the Court to accept the lawsuit arguing that: (i) the Administrative Court has jurisdiction to analyze and resolve such lawsuit in accordance with the Internal Regulations of the Administrative Court even though such law does not specifically establish that an admonition is challengeable; (ii) an admonition issued by the CNBV is a final and definitive resolution that harms the CPA; and (iii) in case the Court dismissed the lawsuit it would be a transgression to the CPA´s right of access to justice.

On 6 November 2017, the Court issued a ruling on the appeal filed by the CPA. In the ruling, the Court established that:

1. The Administrative Court generally has jurisdiction to review fines and non-economic sanctions. This means it may review:
    (i) decisions issued by administrative authorities that impose fines or other sanctions through an administrative procedure; and
    (ii) decisions by administrative authorities that resolve internal appeals challenging an administrative fine or sanction.

2. The Administrative Court has jurisdiction to analyze the lawfulness of administrative decisions issued by the CNBV because article 23 of the Internal Regulations of the Administrative Court establishes that the Court is a Specialized Chamber that will analyze and resolve lawsuits related to decisions issued by administrative authorities, such as the CNBV.

In summary, the admonition issued by the CNBV is challengeable by the filing of a nullification proceeding because:

1. Such admonition was issued by the CNBV, whose decisions are within the jurisdiction of the Administrative Court;

2. Even though the Internal Regulations of the Administrative Court do not specifically consider admonitions as a sanction that may be challenged before Court, admonitions are sanctions issued by an authority and are therefore similar in legal nature to the sanctions that the Specialized Chamber is explicitly authorized to review (fines, decisions issued by administrative authorities that ends an administrative procedure and decisions that resolve internal appeals).

This ruling from the Administrative Court confirms our interpretation that an admonition issued by the CNBV to a CPA is challengeable before Court, therefore, the right the access to administrative justice was granted.

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The Netherlands

Decisions imposing fines on accounting firms for breaching their duty of care annulled

Introduction

On 16 March 2016 the Netherlands Authority for the Financial Markets (the AFM) fined the big four accounting firms operating in the Netherlands: Deloitte, EY, KPMG and PwC (the Big Four) millions of euros.[1] We reported on these fines in our March/April 2016 update.

These fines resulted from the AFM's random check of audit opinions issued by the Big Four, which led the AFM to conclude that the firms had breached their duty of care by failing to ensure that all their auditors comply with the auditing rules. In several cases, the AFM concluded that the auditor issued an audit report without obtaining sufficient and appropriate evidence. Thus, the AFM concluded that auditors failed in auditing the financial statements with due care for the years 2011 and 2012 and imposed fines for those violations.

EY appealed the AFM's fine decision to the District Court of Rotterdam (the **Court**) and on 20 December 2017 the Court issued a judgment annulling the fine.[2]

Subject of appeal

The duty of care, as stipulated in article 14 and article 25 of The Audit Firms Supervision Act (the Wta), obliges accounting firms to ensure that its auditors comply with the general administrative rules related to professional competence, objectivity and integrity. According to EY, the AFM wrongfully found that EY breached article 14 Wta after reviewing only several audit files. EY argued that a more thorough investigation by the AFM was required in order to support a conclusion that EY breached its duty of care.

Judgement

The Court reasoned that due to the punitive character of a fine, the proof required to substantiate a breach of the duty of care is bound by strict rules. In addition, the Court noted that individual external auditors, as well as the audit firm, are responsible for compliance with the rules that safeguard the quality of the statutory audits. The court explained that this responsibility is incorporated in the general standard of article 14 Wta and the rules that mandate quality control measures at accounting firms. Thus, the quality control practices of the firm must be investigated in order to establish whether an audit firm has complied with its statutory obligation and specifically whether it exercised the required duty of care.

The Court explained that such an investigation could conclude that the audit firm has not complied with its duty of care but find no actual failures in the performance of audits. In other cases, failures in an audit may indicate a breach of the duty of care. However, such failures are not alone sufficient to conclude that audit firm breached its duty of care.

The AFM fine decision was supported only by a statement that – given the nature, severity and amount of failures in the audits caused by the external auditors – the audit firm breached its duty of care by making insufficient efforts to ensure the external auditors complied with their statutory obligations. The Court concluded that the AFM had failed to *demonstrate beyond a reasonable doubt* that the accounting firm breached its duty of care. The Court also concluded that the AFM did not support the decisions by specifically demonstrating how the accounting firm breached its duty of care.

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1 The various decisions of the AFM and the fine amounts can be found here (Dutch only).

2 District Court of Rotterdam 20 December 2017, ECLI:NL:RBROT:2017:9977.

Conclusion

The strict rules of furnishing proof and substantiating a fine decision led to the annulment of the fines levied against the Big 4. The Court's judgment not only raises the bar for the evidence the AFM must develop in order to support imposition of future fines but also provides guidance about how a breach of an accounting firm's duty of care can be established.

The AFM is currently considering appealing the judgment of the Court.

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The United States

Auditors liable to FDIC for failing to design audit to detect fraud in Colonial BancGroup Case

Big Four accounting firm PricewaterhouseCoopers LLP (PwC) "did not design its audits to detect fraud and PwC's failure to do so constitutes a violation of the auditing standards," ruled U.S. District Court Judge Barbara Jacobs Rothstein on 28 December, 2017, in connection with PwC's audits of Colonial BancGroup, Inc. (Colonial)—one of the largest banks to fail during the 2008 financial crisis.

Both Colonial and the Federal Deposit Insurance Corporation (FDIC) filed separate lawsuits against PwC in 2011 and 2012 for failing to detect a multibillion-dollar fraud that ultimately led to Colonial's demise. The liability phase of the trial concluded on 13 October, 2017. In a 92-page decision, Judge Rothstein rejected the claims brought by Colonial and its holding company on the ground that they were barred by the in pari delicto doctrine—which bars a party who participated in wrongdoing from recovering damages. The wrongful conduct of Colonial's employees, who were complicit in the fraud, was imputed to Colonial and barred the bank from recovering from its auditors, ruled Judge Rothstein.

But Judge Rothstein ruled that the FDIC which stands in the shoes of Colonial as receiver for the failed institution could recover from PwC on a professional negligence claim. In a prepared statement PwC said "[t]he FDIC was only able to prevail on the claim that it did based on an earlier novel ruling by the Court that immunized the FDIC from imputation-based defenses." The Big Four accounting firm "intends to appeal the novel ruling at the earliest possible opportunity."

A second phase of the trial will follow to determine the amount of damages the FDIC is entitled to. According to the FDIC's court filings, Colonial's failure cost the FDIC deposit insurance fund $2.3 billion. Judge Rothstein's decision reduced the potential damages to an estimated $1.4 billion. PwC has stated that it "looks forward to the damages phase where the FDIC will bear the burden of proof on what remains of their inflated damages claim."

See Colonial BancGroup, Inc. v. PricewaterhouseCoopers LLP, No. 2:11-cv-00746-BJR-TFM (M.D. Ala. Dec. 28, 2017).

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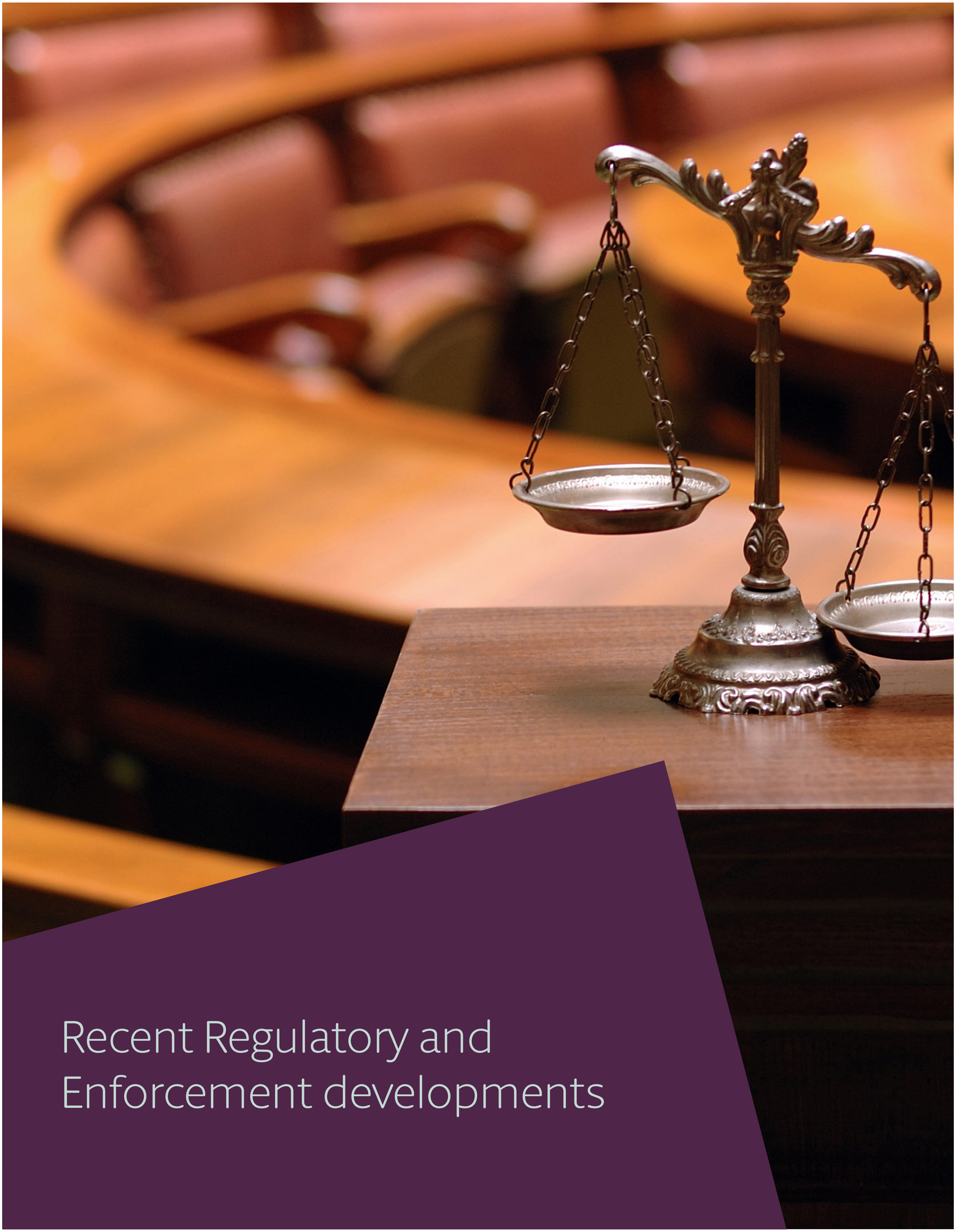

Recent Regulatory and Enforcement developments

Italy

With the law 19 October 2017, no. 155, the Italian Parliament has delegated to the Government the power to adopt one or more legislative decrees to reform, inter alia, insolvency procedures. Even though much will depend on the operative choices that will be adopted by the Government in the course of 2018, the recently passed law already includes interesting new features for auditors and auditing firms.

Indeed, the Government has been specifically given the power to introduce alert and restructuring procedures aimed at incentivizing the early surfacing of companies' financial crisis and facilitating negotiations between debtors and creditors. Against this background, Article 4 of the new law assigns to the Government the task of imposing upon auditors and auditing firms the duty to immediately notify the administrative body of the company that elements of a financial crisis exist. In case the administrative body fails to properly respond, the same notification shall be made to a competent body for assistance of the debtor, which (according to the new law) shall be established at each chamber of commerce.

Pursuant to Article 14 of the new law, the Government is also authorized to amend the Italian Civil Code and, in particular, to extend the scope of application of the rule requiring limited liability companies to appoint a supervising body or an auditor, which will be compulsory when the company for two consecutive fiscal years fails to satisfy at least one of the following requirements: *(i)* asset side of the balance sheet exceeds 2 million euros; *(ii)* revenues exceed 2 million euros; *(iii)* average number of employees during the fiscal year exceeds 10 units. Such obligation ceases to have effect when none of the three said pre-requisites are met for three consecutive fiscal years.

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Spain

Bankia IPO Case: Deloitte S.L. and one of its auditors to face criminal charges

On 17 November 2017, the Investigating Central Court of the Spanish National Court (Juzgado Central de Instrucción de la Audiencia Nacional) ruled that Deloitte S.L., and the Deloitte partner who signed Bankia's inaccurate financial statements will face criminal charges related to Bankia's fraud.

In deciding that a criminal trial should move forward, the Judge considered the fact that a previous Spanish National Court decision reversed Deloitte's earlier acquittal on Bankia-related charges and that the Spanish Accounting and Account Auditing Institute (ICAC) has initiated disciplinary procedures stemming from alleged fraud in the auditor's report. The Judge concluded that Deloitte and the partner must face criminal charges because the Spanish National Securities Market Commission (CNMV) relied on their report when deciding to approve the Bankia IPO.

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EQUAL

The United States

SEC approves PCAOB's New Auditor Reporting Standard

On 4 December 2017, the U.S. Securities and Exchange Commission (SEC) charged the California-based audit firm Anton & Chia, LLP (A&C), three of its partners and a manager with violations of federal securities laws and improper professional conduct in connection with its audits of various microcap companies.

The SEC alleged that the respondents, in auditing the financial statements of three different companies—Accelera Innovations, Inc. (Accelera), Premier Holding Corporation, and CannaVEST Corp.—"egregiously deviated from multiple standards of the Public Company Accounting Oversight Board." The SEC's Enforcement Division said in a statement that the accounting firm "ignored numerous indications of fraudulent financial reporting" by its three clients.

For example, A&C and the individual respondents allegedly facilitated the fraud perpetrated in Accelera's financial statements—a fraud in which Accelera materially misstated its revenue by reporting revenues of a purported subsidiary that it never actually acquired. The SEC alleged that the respondents knew, or were reckless in not knowing, that Accelera never consummated the acquisition of the purported subsidiary.

The case is to be scheduled for a public hearing before an administrative law judge.

Global accounting firm settles allegations that it violated PCAOB quality control standards for US$1.5 Million

On 19 December 2017, the Public Company Accounting Oversight Board (PCAOB) entered a US$1.5 million settlement resolving allegations that Grant Thornton LLP (Grant Thornton) violated PCAOB rules, quality control standards, and auditing standards in connection with audits of Bancorp—a Philadelphia-based financial services provider.

"Prior to the Philadelphia office's year-end 2013 audits, Grant Thornton had significant concerns with the proficiency and technical competence of two engagement partners in its Philadelphia office's financial services group," said the PCAOB disciplinary order. "Despite those concerns, Grant Thornton failed to take sufficient steps to properly support or monitor the [engagement partners] when it assigned each to serve as an engagement partner on two separate 2013 issuer audits for financial services clients."

In addition to censuring Grant Thornton and imposing a $1.5 million civil penalty, the PCAOB ordered Grant Thornton to arrange for a member of its national professional practice department to review, on a temporary basis, the audit work of each of the audits of financial services clients prepared by Grant Thornton's Philadelphia office; to engage a non-Philadelphia office reviewer to each audit of a financial services client in which the Philadelphia office is involved; and to provide additional financial-services-related professional education to its Philadelphia office employees.

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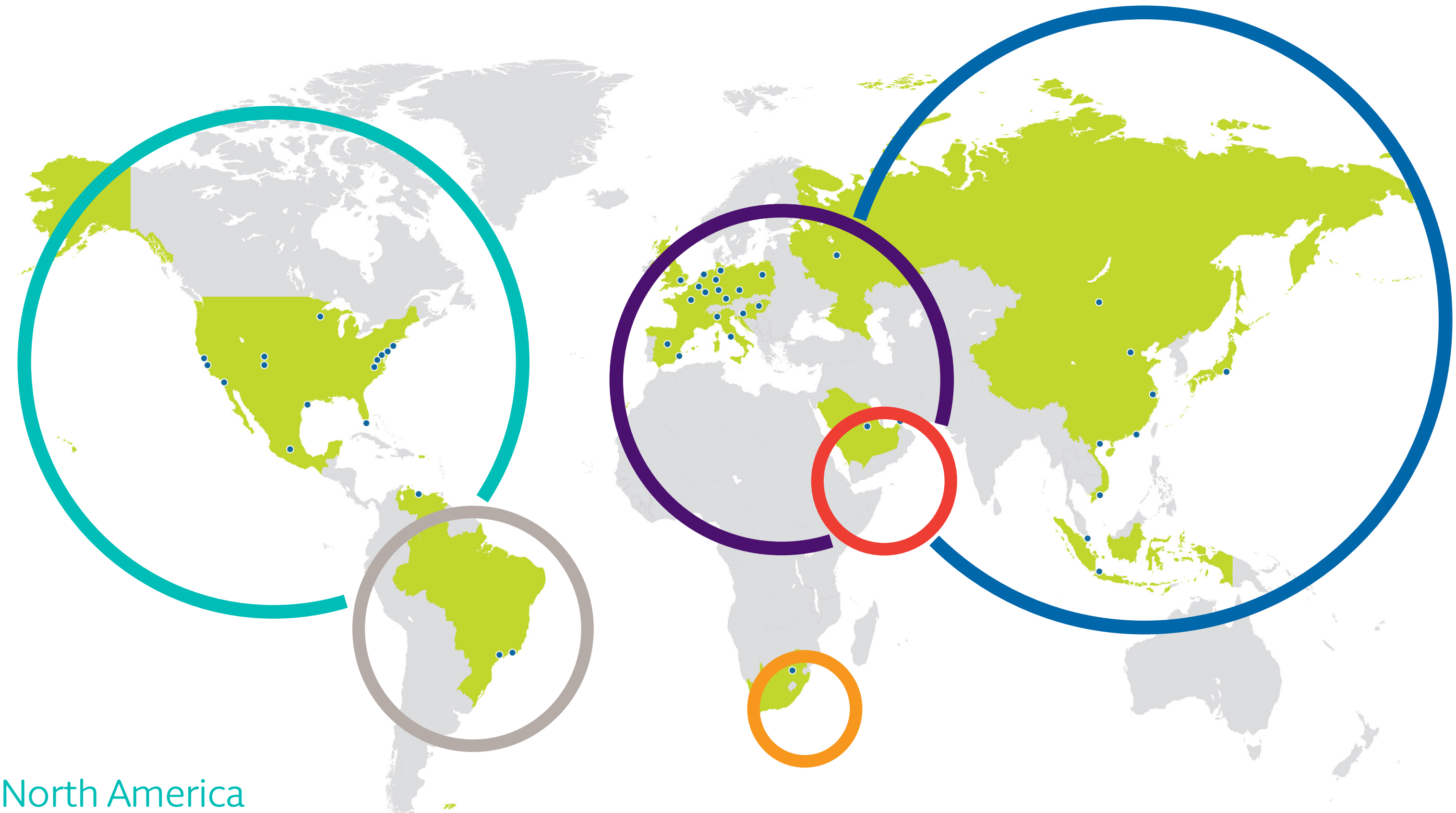

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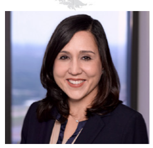

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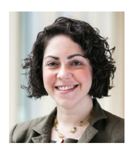

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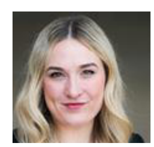

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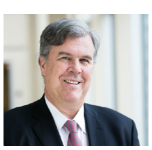

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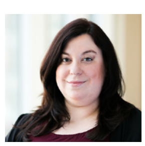

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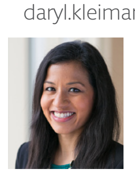

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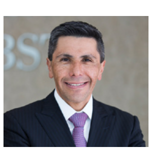

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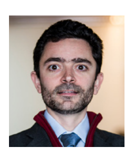

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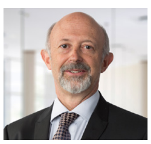

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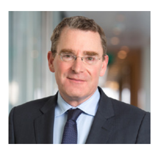

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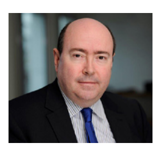

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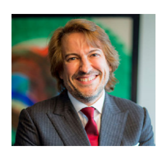

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