Hogan Lovells

Global Accountants' Liability Update

November and December 2016

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A legal practice 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. Our team recently researched legal and regulatory developments related to auditors' liability in Germany, Mexico, the Netherlands, Spain, and the United States. We have experienced lawyers in each of these jurisdictions 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. This month, our team identified developments of interest in Mexico, the Netherlands, Spain, and the United States, which are summarized in the pages that follow.

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The Netherlands

Recent Court Decisions

Accountants' findings warrant a disciplinary reprimand but not civilly liable

Introduction

In our January/February 2016 Accountants' Liability Update, we outlined the distinct standards for disciplinary action against an accountant and civil liability for damages arising from an accountant's conduct. A recent case again underscores that these two tribunals do not apply the same standard. Here, the highest disciplinary court for accountants, the Trade and Industry Appeals Tribunal, issued a reprimand to an accountant for actions that a civil judge subsequently found did not justify civil liability.

Facts

A forensic accountant was engaged to investigate representations made by a former director of the accountant's client during salary negotiations. The client suspected that its former director had falsely inflated his previous salary during negotiations with the company. The accountant concluded that the former director had indeed presented a falsified employment contract to the company. After the client relied on this finding and terminated the director, he challenged the accountant's findings through a disciplinary proceeding and a civil action for damages.

Disciplinary proceedings

The disciplinary court found that the company had informed the accountant that it hoped to press criminal charges against the former director. With this knowledge, the accountant should have exercised special care during the investigation. The court found that the accountant failed to exercise that required care by concluding that the former

director had presented a falsified employment contract to the company without verifying what version of the contract company representative actually received. The disciplinary court thus reprimanded the accountant for issuing a report that was insufficiently substantiated.

Civil liability

In the civil case, the former director sought damages stemming from his termination and from reputational harm. Although the former director sought to rely on the findings of the disciplinary court, the civil judge explained that the liability standard in a civil action differs from a disciplinary action. Namely, in a civil action, the judge must determine whether the defendant acted wrongfully and whether his actions create an obligation to compensate the damage suffered.

The civil judge concluded that although there was a possibility that the contract presented to the company by the former director was not falsified, this was unlikely. Thus, the court concluded that it was most likely that the director was dishonest about his previously earned salary and he himself was responsible for the forensic accountant's findings. This reasoning led the court to deny the former director's claim for damages.

Conclusion

It is clear that disciplinary courts and the civil courts apply different standards. Here the accountant's actions that justified a disciplinary reprimand did not support civil liability. The disciplinary court focused solely on the conduct of the accountant. In contrast, the civil judge scrutinized the former director's conduct. Thus, these two tribunals not only apply different standards but will also weigh the facts differently.

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The United States

Auditor to pay zero damages to technology company despite misrepresentation

A California federal jury found in November 2016 that the CPA firm, Miller Kaplan Arase & Co. ("Miller Kaplan"), owed no damages to the plaintiff, PNY Technologies Inc. ("PNY") for knowingly making a false representation to PNY while auditing its patent licensing deal with SanDisk. The jury in the U.S. District Court for the Northern District of California found that, despite the accounting firm's false representation concerning its objectivity to PNY, Miller Kaplan had not caused SanDisk to stop conducting business with PNY or to even initiate a legal action against PNY, and therefore caused no harm to PNY and owed no legal damages. *PNY Technologies Inc. v. Miller Kaplan Arase & Co. LLP, 3:15-cv-01728*.

The two-week jury trial was predicated on a 2008 licensing deal between PNY, the seller of USB and flash memory devices, and SanDisk, for whom PNY was a licensee. Pursuant to the contract, SanDisk could hire an independent auditor to audit PNY's compliance with royalty payments to SanDisk.

PNY alleged that Miller Kaplan both concealed its existing relationship with SanDisk from PNY while auditing PNY's compliance with the SanDisk agreement and also shared PNY's confidential documents with SanDisk. PNY alleged that Miller Kaplan violated the American Institute of Certified Public Accountants standards and sought $13 million in lost profits and $11 million in attorney's fees.

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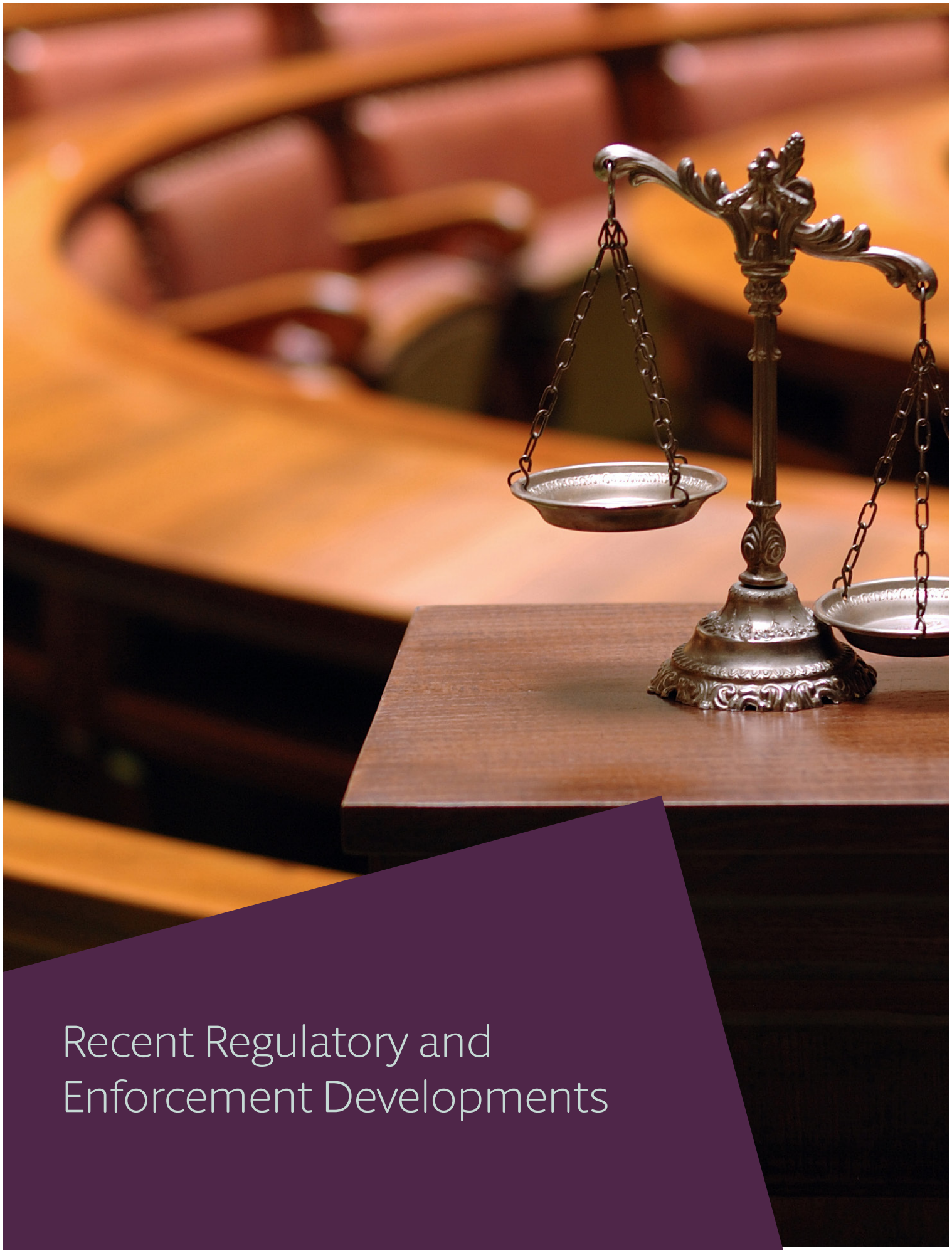

Recent Regulatory and Enforcement Developments

Mexico

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Mexico City authorities consider capital gains tax

Background

On 1 January 2016, after a long political struggle, the Federal Congress amended the Constitution of the United Mexican States ("Federal Constitution") in order to make several changes regarding the political regime and autonomy of the former Federal District (Distrito Federal) to become the newly named Mexico City.

Article 122 of the Federal Constitution outlines regulation of Mexico City. Before the constitutional amendment, the federal powers (executive and legislative) had direct influence over certain matters of Mexico City, including its Organic Statute (similar to a local Constitution). Following the reform, local authorities have complete control over the City and are even authorized to draft a local Constitution (CDMX Constitution).

November's update

On 15 September 2016, the Head of the Executive Branch of Mexico City ("CDMX Chief") submitted to the Mexico City's Constitutional Congress a draft CDMX Constitution that includes articles — Articles 21 (C, 7 and 10) and 26 (A, 8) — providing for a capital gains (plusvalía) tax on real estate sales. These provisions have been widely criticized by the Constitutional Congress as well as by social media and the press.

Critics allege that the capital gains provisions impose a new tax on the citizenship due to recent reductions in funds to the City. Specialists in urban development counter that capital gains taxes are used in many countries (even in Mexico with the "contribution for improvements" [derechos de mejora]) and will be paid by large real estate construction corporations, not citizens.

In response to the public's negative reaction to the proposed new tax, the Constitutional Congress has reportedly decided to remove article 21 (C, 7). However, it is not clear if the other articles relating to capital gains will remain.

The CDMX new provisions are not completely clear and thus legislators will likely be in a position to define the scope of any new capital gains tax. The CDMX Constitution is expected to be issued in 2017 and could significantly shape local taxation matters.


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Spain

Former Deloitte directors indicted in relation to Abengoa audit

The Spanish National Court has indicted all of Deloitte's directors in charge at the time of the alleged audit failures at Spanish energy giant, Abengoa. An action filed on 15 November 2016 in the National Court requires Deloitte's directors to answer before the Court to the charges of unfair administration and falsification of both accounting documentation and economic-financial information.

Abengoa, once a leader on renewable energy, is now immersed in a very tough financial restructuring process. The terms of that restructuring are defined by an agreement executed with its creditors and approved last 8 November by the Commercial Court of Seville. Deloitte was Abengoa's auditor during the last years and will now be required to respond to allegations that its audit failures contributed to Abengoa's insolvency.

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The United States

Deloitte Brazil fined record $8 Million by PCAOB for false audit reports

Brazil-based Deloitte Touche Tohmatsu Auditores Independentes (Deloitte Brazil) will pay an $8 million fine—the largest civil penalty every imposed by the Public Company Accounting Oversight Board (PCAOB)—to resolve allegations that it issued false audit reports to airline, Gol Intelligent Airlines (Gol), and later tried to cover it up by providing false testimony and improperly altered documents to the PCAOB during a 2012 investigation. Deloitte Brazil's admission that it did not cooperate with PCAOB's 2012 investigation into Deloitte Brazil's 2010 audit of the airline's financial statements is the first admission of wrong-doing ever made by a global network firm in a PCAOB settlement. See In re Deloitte Touche Tohmatsu Auditores Independentes, PCAOB Release No. 105-2016-031 (Dec. 5, 2016). Twelve former partners and other officials were also separately sanctioned for their roles in the scheme.

While Deloitte Brazil admitted to some of the PCAOB's findings, including altering documents during the PCAOB investigation and failing to ensure its employees' compliance with ethical principles, the firm did not deny or admit whether its audit violated any laws or PCAOB standards or whether its employees lied under oath. Id.

When the PCAOB began its investigation of Deloitte Brazil's Gol audit in 2012, a Deloitte partner who has since been terminated instructed other members of Deloitte's Gol engagement team to alter documents that were part of the audit work papers Deloitte produced to the PCAOB. Some Deloitte Brazil employees also falsely testified to the PCAOB investigators under oath.

In addition to the fine, the settlement requires Deloitte Brazil to retain an independent monitor to evaluate and report on its compliance with the settlement order, implement certain quality control remediation policies, and provide additional professional training to its personnel. The settlement also censures Deloitte Brazil and prohibits it from issuing and preparing audit reports for certain new clients until Deloitte Brazil has complied with quality control remediation requirements.

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The United States Cont.

EY Settles Charges with SEC for Audit Failures

In late 2016, Ernst & Young LLP (EY) settled charges brought by the Securities and Exchange Commission (SEC) related to its audit of an oil services company that used misleading income tax accounting to increase its earnings. EY agreed to pay the SEC more than $11.8 million in disgorgement and penalties, in addition to the payment of a $140 million penalty by its audit client, Weatherford International, and two Weatherford employees. EY and its two partners consented to the SEC order without admitting or denying the SEC's findings that they engaged in improper professional conduct.

The SEC charged EY with disregarding significant red flags—despite the SEC having designated the Weatherford audits as high risk—that allegedly would have uncovered Weatherford's fraud. The SEC noted that, although the EY audit team was aware of the post-closing adjustments Weatherford was making to substantially decrease its income tax year-end provision, it failed to conduct the requisite audit procedures to evaluate Weatherford's accounting and instead relied on Weatherford's explanations. *See In re Ernst & Young LLP, Craig Fronckiewicz, and Sarah Adams, Exchange Act Release No. 79109 (Oct. 18, 2016)*.

The two EY partners who had coordinated the audits were also charged with ignoring key red flags during Weatherford's annual audits and quarterly reviews. Both partners were suspended from appearing or practicing as accountants before the SEC, but with the right to apply for reinstatement after a set time period.

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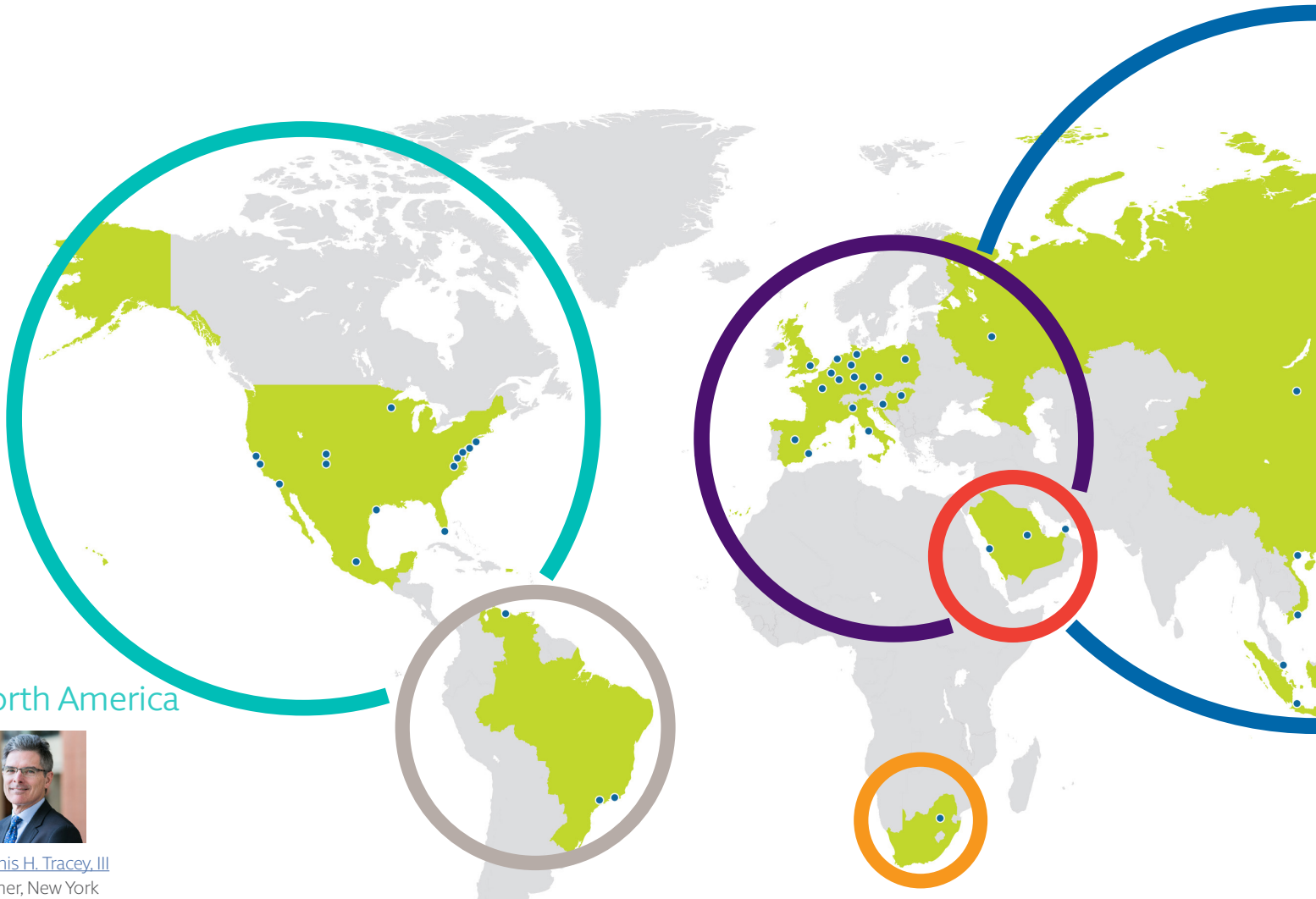

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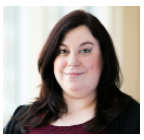

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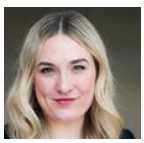

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