Hogan Lovells

Global Accountants' Liability Update

May and June 2017

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. Our team recently researched legal and regulatory developments related to auditors' liability in Germany, Hong Kong, 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 Hong Kong, The Netherlands, Spain, and The United States, which are summarized in the pages that follow.

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Recent Court Decisions

Hong Kong

Court of Appeal stays publication of Disciplinary Committee decision pending appeal

In June, the Court of Appeal established that a decision issued by the Disciplinary Committee of the Hong Kong Institute of Certified Public Accountants may be withheld from publication and stayed while an appeal is pending. The court considered the legislative intent of s.38(2) Professional Accountants Ordinance (PAO) and concluded that the clear legislative intent was that while an appeal is pending: (1) any reprimand, penalty and costs order are not to be made public; and (2) the penalty and costs order are not to be enforced. The court explained that making any such reprimand public would essentially give it effect.

Turning to the question of whether an injunction preventing publication of the decision was warranted in this case, the court indicated that it was a matter of balancing competing interests. The public's interest in knowing the outcome of disciplinary proceedings in a timely manner must be weighed against the need to protect individuals from adverse effects of a sanction while an appeal is pending.

The statutory intent to protect the individual was given much weight against the other material factors (the public interest considerations, the reasonable prospects for success of the appeal, and the potential damage to professional reputation). Accordingly, the Court ordered that the Disciplinary Committee decision not be published and that it should be stayed until the final determination of the respondents' appeal or further order.

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The Netherlands

Court of appeals considers scope of accountant's duty of care

Introduction
Recently, the Court of Appeals Arnhem-Leeuwarden ruled that an accountant did not exercise the required duty of care (zorgplicht). In so finding, the Court of Appeals offered guidelines for the interpretation and the scope of the accountants' duty of care.

Facts
In the present case, the accountant advised the SRI-group, which produces machines for industrial cooling, to adopt a holding structure that made it possible to take advantage of a favourable tax regime that regarded corporate entities as a tax group or fiscal unity (fiscale eenheid). Dutch tax law stipulates that a fiscal unity is allowed when a parent company owns 95% or more of the shares of its subsidiary. The advantage of such a tax group is that intercompany transactions are not taxed and profits of one company can be set off against losses of the other. The SRI-group requested – with the assistance of its accountant – and was granted fiscal unity status.

Due to financial difficulties, at a certain point in time a cash injection was required and one of the group entities sold a 20% interest of a subsidiary to a third party. Consequently, the fiscal unity was terminated because the statutory threshold of ownership (95%) was no longer met.

The accountant did not warn the SRI-group that the fiscal unity would be terminated under such circumstances. As a result of the termination, a EUR 1,500,000 intercompany real estate transaction, which would not have been taxable if the fiscal unity remained in place, was taxed at 20% to 25%.

Ruling of the Court of Appeals
An SRI-group entity sued the accountant alleging that he breached contractual obligations and/or that he committed an unlawful act by not informing the entity of the consequences of fiscal unity termination.

After finding no contractual liability, the Court of Appeals considered the scope of the accountant's duty of care to its client. This duty of care is rooted in the accountant's obligation to act with due care as may be expected from a reasonably competent and reasonably acting accountant. This requires that the accountant avoid exposing his client to foreseeable and avoidable risks.

In addition, an accountant advising his client during a transaction has an obligation to enable his client to make a well-informed decision. The circumstances of the case dictate whether an account must inform and warn his client about a specific risk. Of importance is the severity and extent of the damages, the likelihood of the risk materializing and the client's awareness of the risk. Under this standard, the accountant is not obliged to notify the client of insignificant, obvious, generally known or theoretical possibilities.

Examining the facts of this case, the Court of Appeals noted that the accountant was involved in all transactions of the group and that the scope of advice he provided included tax advice. He was aware that the fiscal unity would be terminated if the transfer of the shares occurred. He nonetheless failed to inform his client about the real (not merely theoretical) possibility of the negative tax consequences of the deal. He thus failed to enable his client, who was not aware of these consequences, to make a well-informed decision. The court found that this failure breached the accountant's duty of care.

Conclusion
In this ruling, the Court of Appeals offers various guidelines relating to the scope of an accountant's professional duty of care. This decision underscores the importance of documenting information provided to clients and of clearly defining and delineating the scope of the accountant's services. If the client is aware that certain advice (e.g. advice relating to tax matters) is outside the scope of services the accountant has agreed to provide, the liability of the accountant in this respect could be limited.

The amount of damages the accountant must pay in this particular case will be established in a separate legal proceeding to establish damages (schadestaatprocedure).

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The United States

New York Appellate Division upholds order compelling PricewaterhouseCoopers LLP to produce audit documents, rejecting accountant-client privilege protection

In a unanimous, unsigned opinion, the New York Supreme Court, Appellate Division, First Department, recently upheld a New York Supreme Court order requiring the production of audit documents prepared by PricewaterhouseCoopers LLP (PwC) in connection with the New York Attorney General's ongoing investigation of ExxonMobil Corp.'s (Exxon) allegedly misleading public disclosures about the effect climate change has on the company's operations. Last October—after Exxon asserted accountant-client privilege under a Texas statute and told the New York Attorney General that it would not permit PwC to disclose any of the requested documents--Justice Barry R. Ostrager ruled: (1) that the Texas statute did not preclude compliance with the Attorney General's subpoena, and (2) the Texas statute was inapplicable to Exxon, because New York law applies to a subpoena issued by the New York Attorney General, and New York does not recognize the accountant-client privilege. The First Department affirmed Justice Ostranger's order. The court's decision noted that "when [courts] are deciding privilege issues, [courts] apply the law of the place where the evidence will be introduced at trial, or the place where the discovery proceeding is located."

This ruling could have broad implications for companies that seek to rely on an accountant-client privilege afforded by the state where the audit took place to protect audit documents from discovery in New York-based proceedings. This ruling confirms that New York courts are unlikely to recognize another state's accountant-client privilege doctrine to protect documents from discovery in New York proceedings.

Court allows securities fraud action to continue against EY, holding audit opinions in connection with registration statements are certifications of financial statements under Section 11

A California federal district court recently declined to dismiss a class action lawsuit against Ernst & Young (EY) brought under Section 11 of the Securities Act of 1933, a provision which creates liability for false and misleading statements made in connection with an issuer's registration statement. In Special Situations Fund III QP, L.P. v. Marrone Bio Innovations, Inc., No. 2:14-cv-02571-MCE-KJN, 2017 WL 1063565 (E.D. Cal. Mar. 21, 2017), a group of investors who bought shares of Defendant Marrone Bio Innovations, Inc. (Marrone Bio) pursuant to a secondary offering, sued Marrone Bio and EY, the auditor who provided the audit report in connection with the secondary offering's registration statement. Plaintiffs alleged that the secondary offering's registration statement is materially false because it relies on audited financials that Marrone Bio's internal audit committee determined should not have been relied upon by investors.

EY moved to dismiss the class action complaint, arguing, among other things, that (1) its audit report issued in connection with the registration statement constituted an opinion rather than a certification of the company's financials; and (2) its audit report was not actionable because plaintiffs' pleading did not meet the standards set forth in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund, 135 S. Ct. 1318 (2015).

Judge Morrison C. England of the District Court for the Eastern District of California denied EY's motion to dismiss, holding that the Section 11 claims were properly pleaded. In response to EY's argument that its audit report constituted an opinion under Omnicare, rather than a certification of the company's financial statements, the Court held that for Section 11 purposes, an audit report is a certification of the financial statements and that an auditor may be held liable under Section 11 for false statements in audited financial statements. Rejecting EY's argument that the audit report is an opinion, the Court stated that an audit report is "not of the same substance as those discussed in Omnicare" and therefore "no amount of couching an audit report as an opinion obviates the certification effect of those reports when made part of a registration statement."

Judge England then proceeded to address EY's arguments on the plaintiffs' alternative theory that, even if the audit report is an opinion, the pleadings satisfied the requirements of Omnicare. First, the Court rejected plaintiffs' argument that the facts of the company's financial statements were "embedded" in the audit report. The Court agreed with plaintiffs, however, that EY could be held liable for the embedded statement in the audit report that EY had conducted its audit in accordance with PCAOB standards, and also that the failure to disclose that the audit was not prepared under PCAOB standards was a material omission actionable under Omnicare.

In rejecting EY's arguments, Judge England parted with the approach taken in the Second Circuit in In re Puda Coal Securities Litigation, 649 Fed. App'x 55 (2d Cir. 2016), a case which we reported about last year. In Puda Coal, the Second Circuit dismissed a similar Section 11 claim against an auditor who had issued a clean audit opinion in connection with what turned out to be a company's materially misleading financial statements. The Second Circuit's decision concluded that plaintiffs had failed to meet the standard for liability for statements of opinion articulated by the Supreme Court in Omnicare.

The Marrone Bio ruling indicates that California is taking a different approach to audit opinions post-Omnicare than the Second Circuit has taken to date. Unlike the Second Circuit, Judge England's decision indicates that California will not require all plaintiffs pleading violations of Section 11 against auditors to meet the strict standards for statements of opinion laid out in Omnicare.

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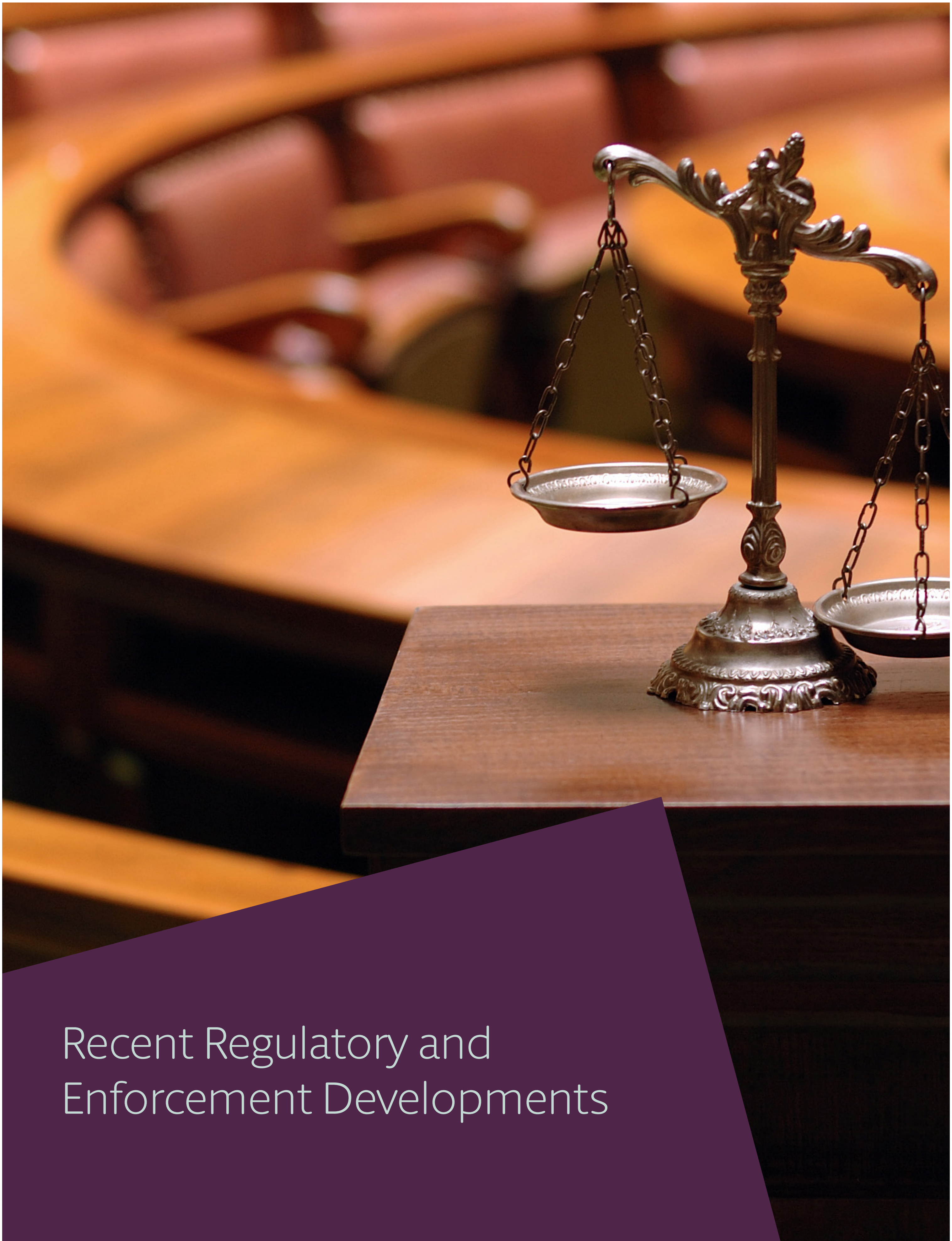

Recent Regulatory and Enforcement Developments

Spain

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New technical guide 3/2017 on audit commissions for Public Interest Entities approved

On 27 June 2017, the Spanish National Securities Market Commission (CNMV) approved a Technical Guide on Audit Committees of Public Interest Entities (PIE).

The Olivencia Code, in 1998, was the first Spanish good governance code, which recommended that listed companies create an audit committee. This obligation was extended to PIEs in 2002 through Law 22/2015, of 20 July 2002, on Audit of Accounts. PIEs are understood to be both listed companies and certain regulated financial entities as well as companies that exceed a certain size (those with more than 4,000 employees and those that net more than 2,000,000,000 Euros in annual sales).

The Guide, which aims to provide a set of principles, recommendations and criteria for the proper functioning of audit committees, enshrines the principles of responsibility, critical attitude and dialogue among members of audit committees and between audit committees and internal auditors, external auditors and management. The Guide further recommends that the composition of audit committees comply with certain criteria for diversity, appointment and training.

The Guide also establishes a system for reporting irregularities and reviewing the financial statements. It also provides new rules governing relations with external auditors, including the nomination and selection process. Finally, the Guide makes it clear that audit committees shall prepare an annual report to be presented to the company at the ordinary general meeting.

The United States

PCAOB adopts new standard concerning auditor's report

On June 1, 2017, the Public Company Accounting Oversight Board (PCAOB) adopted a new auditor reporting standard. If approved by the U.S. Securities and Exchange Commission (SEC), the new standard would impose additional disclosure requirements on auditor's reports, including communication of "critical audit matters" (CAMs).

Under the new standard, auditors would be required to identify in their reports any CAMs arising from the current period's audit of the financial statements, or state explicitly that the auditor determined that there were no CAMs for the period.

The standard defines CAM as follows:

— A matter that was communicated or required to be communicated to the audit committee and that:

1. Related to accounts or disclosures that are material to the financial statements, and,

2. Involved especially challenging, subjective or complex auditor judgment.

And requires the following information to be disclosed in the auditor report: (1) identification of the CAM; (2) description of the principal considerations that led the auditor to determine that the matter was a CAM; (3) description of how the CAM was addressed in the audit; and (4) reference to the relevant financial statement accounts or disclosures. Communications of CAMs is not required for audits of brokers and dealers; investment companies other than business development companies; employee stock purchase, savings, and similar plans; and emerging growth companies.

In addition to CAMs reporting, the new standard also requires additional disclosures aimed at clarifying the auditor's role and responsibilities related to the audit. These additional disclosure requirements, include the following:

1. Auditor tenure – Under the new standard, the auditor's report will include a statement disclosing the year in which the auditor began serving consecutively as the company's auditor.

2. Independence – Under the new standard, the auditor's report will include a statement that the auditor is required to be independent.

3. Enhancements to basic elements – The new standard would change certain standardized language in the auditor's report, including adding the phrase, "whether due to error or fraud," when describing the auditor's responsibility under the PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements.

4. Addressees – Under the new standard, the auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted).

If approved, the new standard will not be implemented all at once. The PCAOB has instead adopted a phased approach. All provisions, other than those related to CAMs, would take effect for audits for fiscal years ending on or after December 15, 2017. For CAMs reporting, the new standard would take effect for audits for fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other applicable companies.

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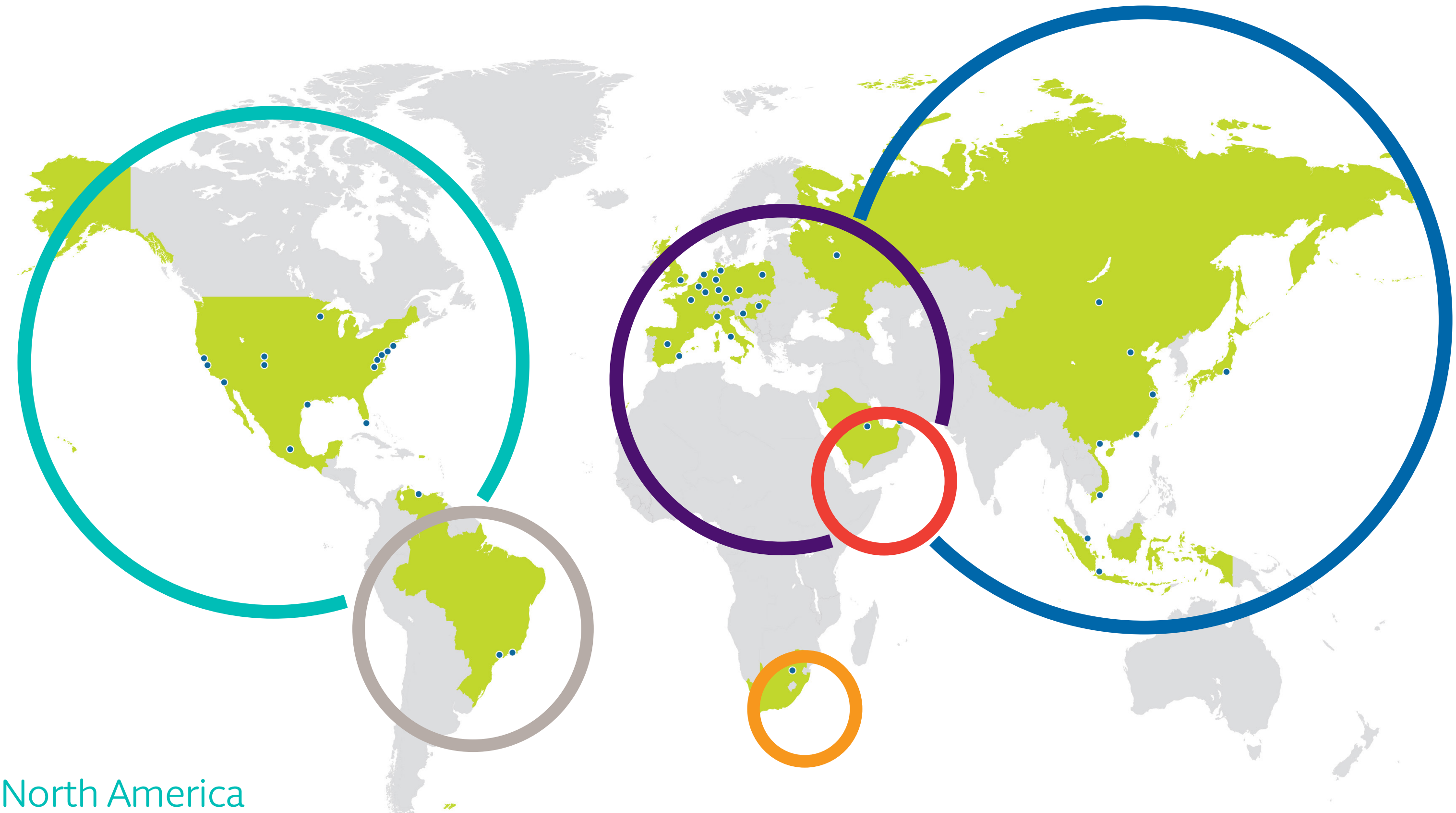

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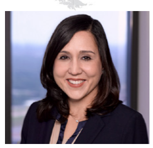

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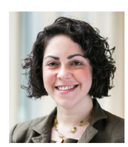

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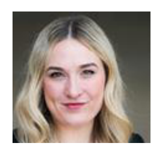

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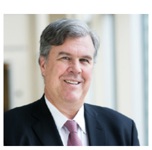

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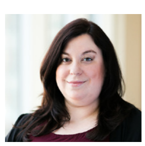

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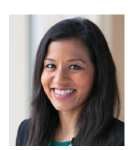

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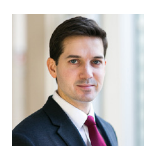

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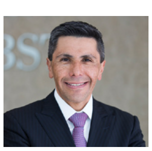

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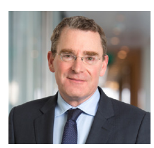

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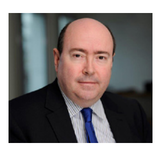

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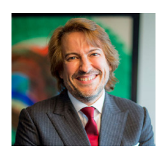

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