
Hogan Lovells

# Global Accountants' Liability Update

## December 2017

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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. 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 October and November 2017 we identified developments of interest in Germany, Hong Kong, Mexico, The Netherlands, Spain, and The United States, which are summarized in the pages that follow.

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# Recent Court Decisions

## Germany

In a recent decision the Higher Regional Court of Braunschweig [Oberlandesgericht Braunschweig], which is a court of appeal in Northern Germany, considered the circumstances under which damages claims brought by investors against accountants are time-barred if the lawsuit was commenced utilizing a mediation institute (OLG Braunschweig, Sep. 11 2017, 10 U 1/17).

The case dealt with the bankruptcy of the "Göttinger-Gruppe" (Securenta).  Thousands of investors brought claims against the accountants of the company.  They argued that the accountants were aware of the fact that that the business model of the company was not sustainable and would ultimately fail, and that, among other things, they breached their duties when auditing the company's accounts.

The Court held that the filing of the claim with the mediation institute could not suspend the statute of limitation because the claims were poorly substantiated by the law firm representing the investors.  The Court held that the claimants failed to specify the likely amount of damages and the remedy sought.  Furthermore, the Court found that because the claimants had not provided information on whether the investment sum was third-party funded, the defendant was not in a position to assess the nature and scope of the claim.

These principles are in line with the established case law of the German Federal Court [Bundesgerichtshof] (cf. BGH, Jun. 18 2015, BKR 2015 383).

It is a popular strategy of claimant law firms for investors to bundle claims and commence proceedings at mediation institutes in order to suspend the statute of limitation and secure more time to attract more claimants. German courts are raising the bar for such actions by tightening the requirements that claims lodged at mediation institutes must meet in order to halt the running of the statute of limitations.

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# Hong Kong

## The Hong Kong High Court, in HCA 1035/2014, affirms that auditors have a duty to detect fraud even where that fraud is committed by a sole controlling director or shareholder

In two suits, companies that were essentially one-man operations sued their auditors for failing to detect fraud orchestrated by the controlling director or shareholder. Each company found itself in liquidation and alleged that its accounting firm breached its duty owed to the company by providing an unqualified opinion on the company accounts and failing to detect obvious fraudulent transactions.

The Court affirmed that auditors have a duty to detect material irregularities in a company's accounting and to report any detected fraud to the company so the company can avoid losses stemming from the fraud. The Court held that this duty exists even where the controlling shareholder or director of the company would have ignored the auditors' reports of fraud and continued to act in a fraudulent manner.

The Court emphasized that internal fraud may be the "very thing" that auditors have a duty to detect, report, and ultimately protect the company from.

*Days Impex Limited (in liquidation) and Days International Limited (in liquidation) v Fung, Yu & Co. (a firm) and Fung, Yu & Co. CPA Limited*

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# Mexico

## Audit Standard Procedures are not mandatory if not published in the Federal Official Gazzette

On 29 September 2017, a non-binding Court decision was published by the Ninth Collegiate Court on Administrative Matters of the First Circuit. The Court unanimously decided that tax authorities may not impose penalties on a public accountant based on audit standards and procedures that have not been published in the Federal Official Gazette. The Court reasoned that issuing penalties for violations of non-published standards breached the recognized principles of legal certainty and publicity.

The Court acknowledged that the audit standards and procedures that the tax authorities relied on to penalize a public accountant were issued by an organization entrusted with the regulation of the skills, independence and impartiality of the work performed by external auditors and that the standards and procedures are technical and mandatory for public accountants. But, the Court held that only such standards that have been published—providing full knowledge of the existence and certainty of such obligations to practitioners—should give rise to a penalty for a breach of professional duty.

The Collegiate Court concluded that the penalty issued by the tax authorities was not permissible because the standards it relied on were not published, and thus, the accountant did not have full knowledge of their existence.

The Court explained that the publicity principle is an essential element of the human right of legal certainty, provided for in Articles 14 and 16 of the Mexican Constitution, as well as in various international instruments executed by the Mexican State, such as the American Convention on Human Rights and the Universal Declaration of Human Rights, among others. The Supreme Court has recognized that the principle of legal certainty mainly relates to obliged parties, and the individuals in general, having full knowledge of standards and regulations established by law and their consequences.

The Court concluded that even though the audit standard and procedures are not tax laws, regulations or administrative provisions, in consideration of the human right to legal certainty, as well as the principle of publicity of general regulations or prohibition of secret regulations, **if the tax authority takes the audit standards and procedures as a basis to impose a penalty in the event of a breach, they shall be published on the Federal Official Gazette to become effective, in accordance with Article 7 of the Federal Tax Code, because only then, will the public accountants have knowledge and certainty of their existence and of the obligations resulting thereof and, will also know which penalty will be applicable to them in case of a breach.**

This non-binding precedent may have repercussions involving other standards applicable to auditors. For instance, the Court's analysis could be extended to a case in which an external auditor is penalized on the basis of the "International Audit Standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants," referred to in the quality and independence standards established by the National Banking and Securities Commission.

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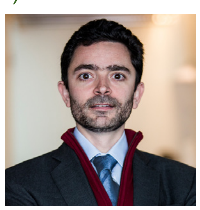

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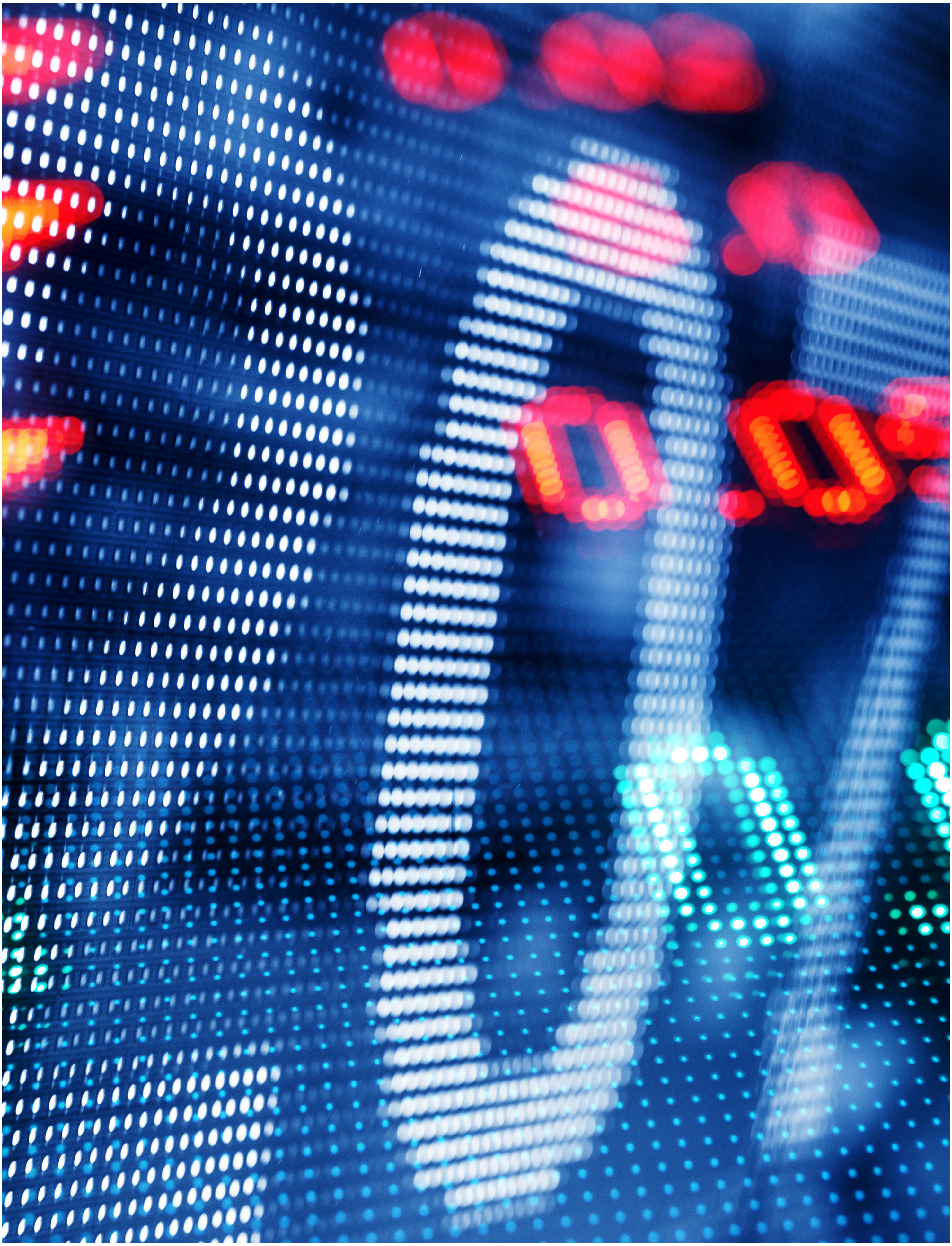

# The Netherlands

## The strengthened obligation for the civil court to state reasons after imposed disciplinary measures

### Introduction

On 22 September 2017, the Dutch Supreme Court rendered a judgment on the liability of an audit firm and an individual auditor (hereinafter jointly referred to as: the "Auditor") for damages resulting from advice rendered in relation to an attempt to obtain funds for the acquisition of shares in a joint venture. Prior to the judgment, the disciplinary court had imposed disciplinary measures on the Auditor. The Supreme Court held that although the disciplinary court's finding that the auditor failed to meet professional standards did not dictate that the civil court find liability, it does establish a heightened obligation for the civil court to identify its reasons to conclude that no liability exists.

### Facts

In the present case the claimant set up a company (the "Company") in 1992 to import flowers from Kenya. The Company set up a joint venture (the "Joint Venture"), with some partners in Kenya, to grow flowers. The Company held 50% of the shares in the Joint Venture, and the other 50% was held by the partners in Kenya.

After a conflict arose between the Company and the partners in Kenya, the Company entered into a share purchase agreement with the partners in Kenya through which the Company agreed to purchase the other 50% of the shares held by the partners in Kenya. The agreement provided that the deal would be terminated prematurely if the Company could not arrange the required funding and provided that the Company would pay EUR 240,000 as a deposit for the takeover.

The Company had instructed the Auditor to assist in resolving the conflict with the partners in Kenya (regarding the purchase of the shares). The Auditor was heavily involved in the envisaged transaction. In addition, the Auditor engaged a third party advisor (the "Advisor") who promised to introduce the Company to potential investors. However, the investors proposed by the Advisor appeared to be uninterested or did not even exist. The Company was therefore unable to arrange the required funding. As a result, the share purchase agreement was set aside and the deposit was never repaid. Due to these financial difficulties, the Company was later declared bankrupt.

### Decision of the Accountancy Division

The owner of the Company filed a complaint against the Auditor claiming that the Auditor exercised insufficient professional scrutiny by failing to conduct a proper investigation into the Advisor's affairs as well as the affairs of the non-existing investors.

The Accountancy Division ruled that the Auditor indeed had not acted with sufficient scrutiny given the heavy involvement of the Auditor in the transaction, its express role in resolving the conflict with the partners in Kenya, and specific communications with the Advisor that the court concluded should have led the Auditor to investigate the affairs of the Advisor. The Accountancy Division concluded that due to these circumstances, the Auditor should have taken a critical attitude towards the Advisor in accordance with the standards for accountants regarding the execution of transaction-related advisory services.

The Accountancy Division found that the complaint was valid and issued a warning to the Auditor in the disciplinary proceeding.

## Ruling of the Supreme Court

After the disciplinary proceedings, the Company initiated civil proceedings seeking damages and a declaratory judgment that the Auditor did not act as a reasonably competent auditor.

The Court of Appeal rejected the claims reasoning that the damages suffered by the Company could not reasonably be attributed to the Auditor's lack of professional scrutiny. The Company subsequently appealed in cassation.

The Supreme Court noted that an auditor being considered guilty or liable in disciplinary proceedings does not necessarily result in civil liability. However, the Supreme Court reasoned that in the event that a civil court deviates from a decision rendered by a disciplinary court, the civil court must substantiate its judgment in order for the civil ruling to be sufficiently comprehensible in the light of the disciplinary decision.

In the underlying case, the Supreme Court ruled that the substantiation of the judgment rendered by the Court of Appeal did not adequately support rejection of the claims. The Court of Appeal accepted the Accountancy Division's finding that the Auditor did not act with sufficient professional scrutiny. However, the Court of Appeal did not take into consideration whether the Auditor should have warned the Company under these circumstances – in which the Auditor was heavily involved in the transaction.

## Conclusion

In its ruling, the Supreme Court concludes that the Court of Appeal had not made it sufficiently clear why the Auditor was not at fault given that court's acceptance of the Accountancy Division's finding that the Auditor did not act with the required professional scrutiny. Although civil courts are not bound by a decision of the disciplinary court, such a decision does create a heightened obligation for the civil court to identify reasons for deviating from such a decision. This obligation serves the purpose to make the civil ruling comprehensible in the light of the disciplinary decision.

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# The United States

## Colonial BancGroup lawsuit tests whether auditors must guarantee against fraud

The first phase of a trial testing whether auditors must guarantee against fraud concluded on 13 October, 2017. The lawsuit—brought by the Federal Deposit Insurance Corporation, Colonial BancGroup, Inc., and Kevin O'Halloran, as the Plan Trustee for Colonial (collectively, Colonial)—alleges Big Four accounting firm, PricewaterhouseCoopers LLP (PwC), failed to properly scrutinize mortgage transactions and uncover the nearly $5 billion worth of fake assets on Colonial BancGroup, Inc.'s balance sheets.

In its closing arguments to U.S. District Court Judge Barbara Rothstein, Colonial argued that PwC violated auditing standards by failing to properly analyze mortgage transactions that ultimately led to the demise of Colonial BancGroup, Inc., one of the casualties of the 2008 financial crisis. PwC's alleged mishandling of its role—on which Colonial, regulators and the public, among others, purportedly relied—resulted in a miss of the fake assets that resulted in an estimated $2 billion in damages. Colonial contended that PwC ought to have treated the transactions as loans rather than sales, improperly relied on third-party confirmations instead of inspecting loan documents themselves, and ultimately never should have certified the bank's financial statements.

PwC countered that the employees within and outside the bank who hid the fraudulent scheme, as well as regulators, were better situated to spot the concealed mortgage loan fraud. PwC also argued that it could not be liable because interference by management in the audit is a defense to negligence under Alabama law—which controls in the case. The bank fraudsters' conduct should be imputed to Colonial because they had acted to satisfy their bank customer, and Colonial employees were aware of the scheme and either failed to inform PwC or collaborated to mislead PwC.

The exact amount of damages will only be determined if Judge Rothstein holds PwC legally responsible, which would trigger a second phase of trial on damages for the years in question of 2003 through 2005 and 2008, while 2006 and 2007 would be argued in a jury trial, the scheduling of which is currently on hold.

A separate trial involving PwC's fellow auditor, Crowe Horwath LLP, is scheduled to begin in November 2017.

*Federal Deposit Insurance Corp. v. PricewaterhouseCoopers LLP et al., No. 2:12-cv-00957; Colonial BancGroup Inc. et al. v. PricewaterhouseCoopers LLP et al., No. 2:11-cv-00746.*

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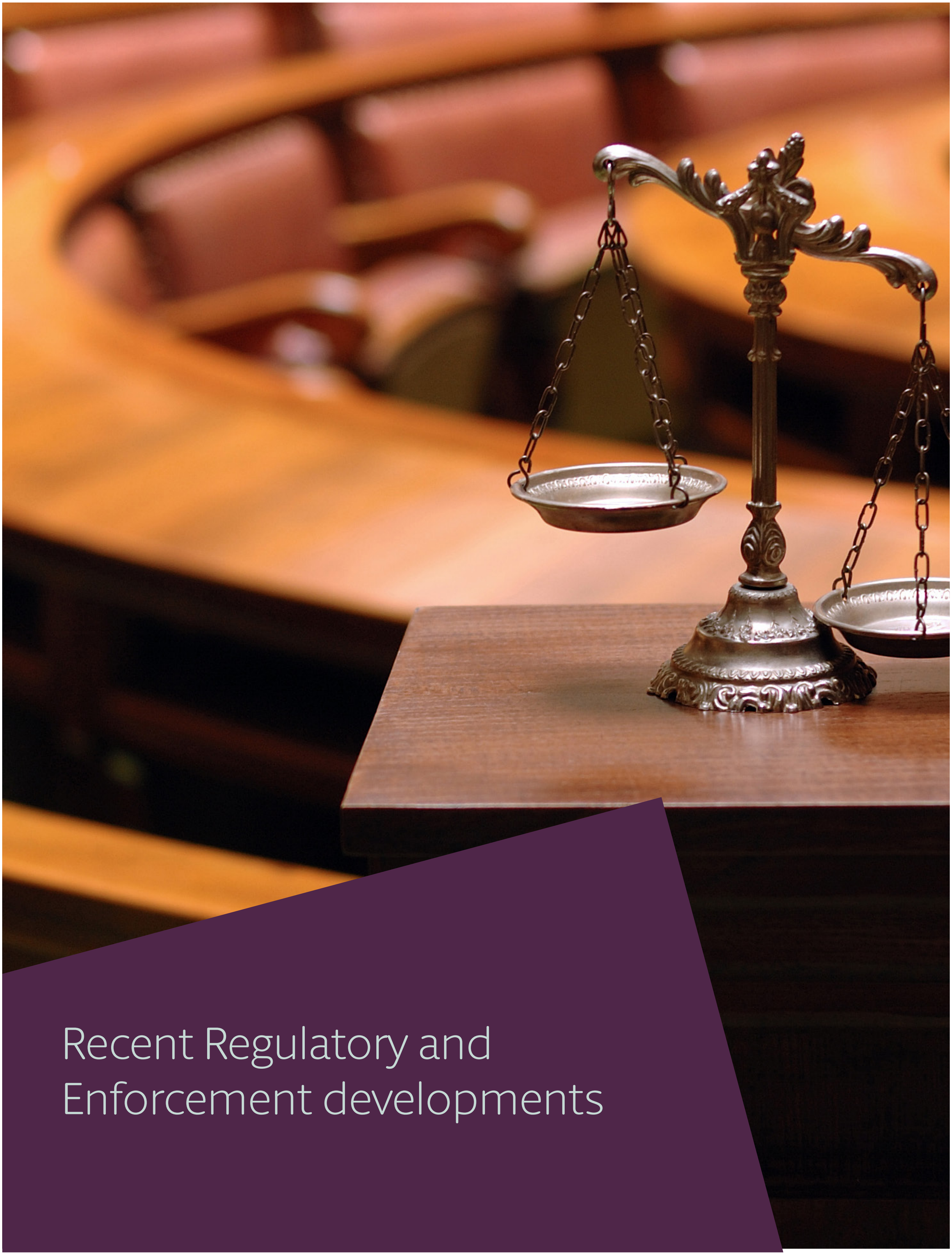

# Recent Regulatory and Enforcement developments

## Bankia IPO Case: The public prosecution is requesting a two-year disqualification period for Deloitte

# Spain

On 15 September 2017, the Spanish National Court (Audiencia Nacional) overturned a lower court decision that had held that Deloitte was subject only to civil charges, and no criminal charges, relating to the "Bankia IPO Case." In May, the lower court had indicted a Deloitte partner for his favorable reports on Bankia's financial statements, acquitted the firm of criminal responsibility, and left Deloitte facing possible civil liability.

In overturning this decision, the Spanish National Court noted that "the partner and the firm make up a unique legal unit, especially since the firm has a quality control system established in its Compliance Manual, which includes the General Policies for all ranges of services." Because "level 2 compliance policies" apply to auditing services, the Court held that, regardless of the partner's independence, Deloitte could also be held criminally liable. Specifically, the Court explained that because the firm supervised all of the partner's actions, and the partner's actions occurred despite compliance requirements applicable to all Deloitte audits, Deloitte could be criminally liable.

On 28 September 2017, the public prosecution accordingly requested that Deloitte be held criminally liable. The prosecution seeks a 3-year-EUR 1,000-a day-fine penalty and a two-year disqualification to carry out any services related to auditing. Auditing currently represents 25% of Deloitte's business in Spain and reportedly generated EUR 636,000,000 in income last year.

## Non-binding opinion from the Accounting and Account Auditing Institute

On 29 September 2017, the Spanish Accounting and Account Auditing Institute (ICAC) published an informative, non-binding opinion addressing the implementation of the new mandatory firm rotation regulation (MFR) in Spain. The MFR requires Public Interest Entities (PIEs) to rotate their audit firms at least once every ten years—after the conclusion of any applicable transitional period—in accord with EU Regulation 537/2014 on specific legal requirements of PIEs (the EU Regulation) as incorporated into Spanish law.

PIEs are understood to be listed companies, certain regulated financial entities, and 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 ICAC opinion addresses an inquiry about a Spanish PIE that had not changed its audit firm since its first financial year in 1995. The query asks which of the Spanish regulations (the original Royal Decree 1517/2011, of 31 October 2011, by which the implementing regulation of the Act on Audit Accounting is approved or the amended version by the Royal Decree 877/2015, of 3 October 2015) constituted the rules applicable to the company so as to know (i) when it would be considered a PIE, and (ii) consequently, which transitional rules would apply to the required change of auditor.

The ICAC held that the first financial year to be taken into account is that in which the entity complied with all of the required legal conditions (Spanish and EU-level requirements) for it to be considered a PIE regardless of the moment in which the definition of a PIE was incorporated into Spanish law. In this specific case, the entity was already complying with all PIE requirements at the time of its incorporation in 1995, nineteen years before the EU Regulation was passed in 2014.

Therefore, article 41.2 of the EU Regulation dictates the relevant transitional rule. That regulation establishes that PIEs that have engaged the same statutory auditor for audit services for more than 11 but less than 20 years may continue to use that auditor until 17 June 2023. Thus, the ICAC concluded that (i) the PIE can maintain its current auditor until 17 June 2023 but (ii) will be obliged to change auditor after that date.

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# The United States

## SEC approves PCAOB's New Auditor Reporting Standard

On 23 October 2017, the U.S. Securities and Exchange Commission (SEC) approved the Public Company Accounting Oversight Board's (PCAOB) proposed rule change intended to make certain public company audit reports more informative. The project—which has been under development by the PCAOB since 2010—was commenced in response to investor requests for independent auditor reports that provide more specific information about how auditors reach their opinions.

The new reporting standard requires that certain public company audit reports communicate "critical audit matters" (CAMs) involving a company's financial statements. CAMs are matters that (i) relate to accounts or disclosures that are material to the financial statements; and (ii) involve challenging, subjective or complex auditor judgment. Auditors will be required to describe in the auditors' report the principal considerations leading to a determination that a matter was a CAM and how the CAM was addressed in the audit.

In its statement approving the PCAOB's proposal, the SEC praised the new rule and its objective of helping investors understand how auditors view complex matters. Although the new rule is supported by various accounting firms and investors alike, at least 15 large companies, such as Chevron Corp. and Nike Inc., and 13 trade groups opposed the rule. The SEC approved the rule change despite this criticism, including criticism by the U.S. Chamber of Commerce that the revised standard would result in the disclosure of immaterial information and would increase liability costs.

In approving the proposal, the SEC urged all those involved in the implementation of the revised auditing standards to pay close attention to certain issues raised by critics—including the risk that the new standard will result in frivolous litigation, defensive and lawyer-driven auditor communications, or antagonistic auditor-audit committee relationships. The SEC highlighted steps taken by the PCAOB to limit and clarify the process for determining what constitutes a CAM, including narrowing the source of CAMs to matters communicated or required to be communicated to the company's audit committee, as well as the materiality component incorporated into the CAM definition.

Communication of CAMs will begin for large company audits in mid-2019 and in late 2020 for all other eligible companies. Auditors are not required to communicate CAMs for "emerging growth companies," as such companies are exempt from certain disclosure requirements for up to five years.

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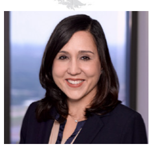

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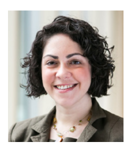

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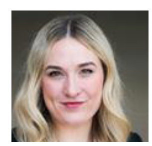

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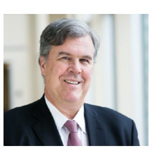

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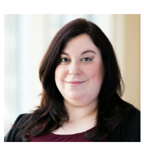

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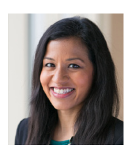

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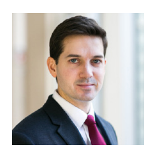

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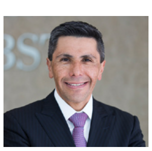

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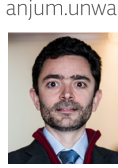

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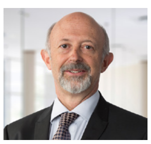

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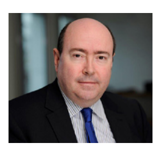

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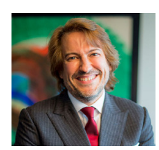

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