Hogan Lovells

Global Accountants' Liability Update

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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 France, Germany, Italy, 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 France, Germany, Mexico, the Netherlands, and the United States, which are summarized in the pages that follow.

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Recent Court Decisions

Germany

Germany's highest court holds that damages of affiliated companies can be calculated on a consolidated basis

In a recently published judgment, the German Federal Court of Justice (Bundesgerichtshof) considered a company group's professional negligence claim against a tax consulting firm. In the case at hand, the majority shareholder of the claimant and another company had asked a tax consulting firm for advice on the tax optimization of the group structure. The tax consulting firm proposed that the majority shareholder establish a foundation in Liechtenstein and transfer its shares in its two subsidiaries to the foundation. Furthermore, as provided for in the concept, the foundation issued an interest-free loan of approximately €12 million to the claimant. Later, the German tax authorities ordered the claimant to pay additional taxes plus interest in the amount of approx. €1.6 million because it had not correctly applied German income tax provisions to the loan. The claimant therefore sued the tax consulting firm for damages.

The court of appeal, the Higher Regional Court of Cologne, dismissed the lawsuit because the claimant failed to show that it suffered a direct damage. The Court held that the claimant received the interest-free loan from the foundation only because the tax concept was implemented. Had the concept not been implemented, the claimant (hypothetically) would have paid higher interest payments to the foundation than it later (actually) paid to the tax authorities. Therefore, the court concluded that the claimant did not suffer damage. The Court considered damage suffered by the foundation to be irrelevant for the claim because: 1) the claimant and the foundation are different legal entities; and 2) according to general principles of German law, only the entity that instructed the tax consulting firm is entitled to claim damages.

In its second appeal to the German Federal Court of Justice the claimant argued that in the hypothetical case stated by the appeal court, the foundation would have received additional hypothetical interest payments from the claimant. In fact, however, the foundation did not receive any such interest payments. It therefore would have suffered damage. The Federal Court held that the claimant was allowed to calculate damages on a "consolidated basis." This was because the financial interests of the foundation fell into the protective scope of the tax advisory agreement. The establishment of the foundation and the loan issued from the foundation to the claimant were substantial parts of the group concept developed by the defendant. The claimant and the foundation were thus treated as an "economic unit" for purposes of calculating damages. The hypothetical interest saved by the claimant was identical with the interest payments (hypothetically) owed by the claimant to the foundation. As a consequence, the claimant suffered damage due to the additional tax payments. Because the first instance court, the District Court of Cologne, had not clarified whether the tax payments were caused by professional negligence at all, the German Federal Court of Justice remanded the case back to the lower court to clarify this point.

This judgment is very important because judgments acknowledging a group doctrine when calculating damages have previously been very rare in Germany. In particular, in cases where the financial interests of a group of companies are affected by a consultancy agreement, this new doctrine can come into play and be of particular relevance for global accountants when acting as advisor.

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Recent Court Decisions

The Netherlands

Netherlands Court of Appeal addresses relationship between a finding that an accountant has violated professional standards and civil liability

On 17 November 2015 the Court of Appeal of Arnhem-Leeuwarden issued an opinion that discussed the differing standards employed in a disciplinary action taken against an accounting consultant (AA) and in civil litigation attempting to establish liability for the AA's actions.

Facts

In this matter, an employee had received a golden parachute (gouden handdruk) from his previous employer. The money he was to receive was put in a special purpose vehicle (SPV) entitling the employee to periodic payments. This arrangement was made because there were tax advantages to making such payments through the SPV rather than directly to the former employee. The AA prepared the employer's annual accounts, the corporate tax return for the SPV and the tax return for the former employee.

Problems arose because, contrary to the terms of the periodic payments agreement, the SPV made no actual payments to the former employee. As a result, the tax authorities levied a penalty because the window during which the periodic payments would have been tax exempt had closed. The SPV and the former employee then sued the AA asserting he was liable for failing to exercise reasonable care. They also initiated disciplinary proceedings against the AA. Both claims were based on the AA's failure to warn his clients about the expiration of the preferential tax treatment for periodic payments made by the SPV.

Disciplinary proceedings

The Chamber for Accountants found that the AA breached his duty to exercise professional scrutiny and to act with due care when he failed to inform his clients about the tax implications of not making the payments from the SPV during the required time period and issued a formal warning.[1]

[1] These principles are laid down in article A-100.4 par. c of the Code of Conduct Regulation.

Civil liability

The lower court adjudicating the civil claim, as well as the Court of Appeal, found no breach of the duty of care and rejected all claims for damages.

In so holding, the Court of Appeal considered the outcome of the disciplinary action in relation to the civil liability matter. First, it noted that the disciplinary law strives to promote good professional practice and is not meant to provide the complainant with (monetary) redress. It then indicated that although the Chamber of Accountant's finding that the AA violated professional standards may be relevant to assessing whether the accountant is civilly liable, such a finding is not determinative because the standard that determines whether a disciplinary complaint is well-founded differ from those that determine whether a civil plaintiff states a civil claim. Moreover, the evidentiary rules offer a defendant greater protections in a civil proceeding.[2] Finally, the Court of Appeal held that the civil duty of care differs from the duty of care at issue in a disciplinary hearing. Despite these differences, the court explained that if the civil court reaches a conclusion that deviates from a related disciplinary decision, the civil court must substantiate its ruling in a way that explains its conclusion in the light of the disciplinary decision.[3]

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2 Dutch Supreme Court 10 January 2013, ECLI:NL:HR:2003:AF0690.
3 Reference is made to a judgment of the Dutch Supreme Court, which consisted of the civil liability of a doctor after a decision of the Medical Disciplinary Tribunal, see Dutch Supreme Court 12 July 2002, ECLINL:HR:2002:AE1532.

Recent Court Decisions

The United States

PWC and Deloitte settle auditor liability claims

PWC settles Fairfield Greenwich class action for $55m

On 6 January 2016, three PwC entities agreed to settle a seven year class action litigation regarding PwC's audit of Fairfield Greenwich Group, a Madoff feeder fund. The plaintiffs, a class of Fairfield investors, agreed to settle all claims against PwC Canada, PwC Netherlands, and PwC International in exchange for $55 million. The PwC entities maintain that the audit work complied with professional standards and deny any wrongdoing. The parties have requested a conference in spring 2016 for the Court to approve the settlement.

According to attorneys for the plaintiffs, Fairfield—the largest operator of Madoff "feeder funds"—managed investments of nearly three thousand investors who lost more than $3.2 billion as a result of Madoff's Ponzi scheme. Plaintiffs alleged that the PwC entities negligently audited the funds from 2002 to 2007. Among other allegations, plaintiffs contend PwC failed to uncover Madoff's Ponzi scheme and wrongly gave the funds unqualified audit opinions.

The matter has a long procedural history. On 19 December 2008, plaintiffs Pasha S. Anwar and Julia Anwar filed a putative class action in New York Supreme Court. A month later the case was removed to federal court. Further actions were filed by additional plaintiffs, and the dockets were consolidated in front of Judge Marrero. The litigation included multiple motions to dismiss, fact and expert discovery, class certification briefing, and a motion for summary judgment. Mediation between the parties began in April 2012 and concluded over three years later in November 2015, when the parties reached a settlement of all claims in the action.

As of this writing, the plaintiffs have collected at least $235 million dollars in damages, including an $80.3M settlement with Fairfield in November 2012 and two separate settlements for $10 million with GlobeOp Financial Services in February 2013, and $125M with Citco Group in March 2015, both of which provided management and administrative services to Fairfield.

The settlement comes on the heels of the first jury trial regarding the auditing of a Madoff feeder fund. There, a Washington state jury found Ernst & Young liable for auditing work performed concerning the Rye funds.

Deloitte settles federal lawsuit brought by Freddie Mac over defunct mortgage lender Taylor Bean & Whitaker

On 20 January 2016, Deloitte & Touche LLP (Deloitte) and the Federal Home Loan Mortgage Corporation (Freddie Mac) filed a joint stipulation of dismissal with the United States District Court for the Southern District of Florida discontinuing with prejudice a lawsuit concerning the now defunct mortgage lender Taylor Bean & Whitaker

Mortgage Corporation (Taylor Bean). The details of the settlement are confidential.

The lawsuit—originally commenced in the Circuit Court for the Eleventh Judicial Circuit of the State of Florida by Freddie Mac—asserted a negligent misrepresentation claim against Deloitte relating to the firm's audit work for Taylor Bean for the fiscal years 2002-2009. Taylor Bean, once the largest U.S. mortgage lender not owned by a deposit bank, sought bankruptcy protection in 2009 after federal authorities uncovered a fraud in which executives created fake, worthless mortgage assets in order to overstate the company's assets and understate its liabilities.

The complaint alleged that Deloitte violated its duties and professional standards by ignoring red flags warning of the fraud occurring at Taylor Bean. From 2002-2009, Deloitte served as Taylor Bean's independent auditor, issuing Independent Auditor Reports for each fiscal year that gave an unqualified opinion on the mortgage lender's audited financial statements and certified that they were free of material misstatement due to error or fraud. Freddie Mac claims that by issuing these reports, Deloitte failed to comply with generally accepted auditing standards and issued statements that were materially false. Among other things, the complaint stated that Deloitte accepted (without verification through independent audit evidence) Taylor Bean management's inconsistent, incomplete, and often last-minute explanations of material transactions, even though the explanations were contradicted by information gathered by Deloitte during its audit. The audit firm was also alleged to have:

(1) "disregarded its own audit plans and failed to perform sufficient audit procedures necessary to audit the accounting treatment of loans sold by" Taylor Bean to Colonial Bank, Taylor Bean's primary financing source, "despite receiving audit evidence that (i) revealed material breaches of the key underlying contractual obligations, and (ii) contradicted the assumption on which Deloitte based its determination that the transactions were true sales under GAAP";

(2) "failed to perform sufficient procedures to properly assess and understand the valuation of Taylor Bean's mortgage servicing rights" even when confronted with inconsistencies between Deloitte's understanding of the business and Taylor Bean's valuations;

(3) failed to understand the relationship between Taylor Bean and Ocala Funding, LLC (Ocala), its wholly owned subsidiary, and to "gather sufficient audit evidence to support its understanding of material inter-company transactions between the two companies";

(4) failed to properly test for fraud in Taylor Bean's revenue;

(5) "failed to apply necessary audit procedures when assessing [Taylor Bean's] allowances for various loan and loan-related accounts, despite being confronted with information indicating that such allowances were either insufficient, unsupported, or missing."

(6) "failed to perform any audit procedures when faced with evidence that [Taylor Bean] was misusing [two warehouse facilities] by transferring non-qualifying repurchased loans to those facilities in violation of the operative agreements"; and

(7) "relied on internal controls and management representations related to asset valuation and sales recognition that it knew were flawed or insufficient to prevent or detect material misstatements."

Freddie Mac claimed that in reliance on Deloitte's audit reports, it purchased billions of dollars of mortgage loans from Taylor Bean. Freddie Mac sought to recover over $1.3 billion in damages from Deloitte.

The action was removed to federal court in October 2014. Deloitte's motion to dismiss was denied by the Court and its motion for summary judgment was pending as of the filing of the parties' joint stipulation of dismissal. Trial was scheduled to begin on 22 February 2016.

This is the fourth lawsuit settled by Deloitte concerning their audit work for Taylor Bean. In October 2014, the firm settled three other suits related to the mortgage lender, two consolidated actions commenced by Taylor Bean bankruptcy trustee Neal F. Lauria and Deutsche Bank, and a third action commenced by Ocala. All three suits alleged that Deloitte certified the company's annual financial statements while ignoring "obvious red flags" of fraud.

borrow billions of dollars it was unable to repay, contributing to the mortgage lender's bankruptcy in 2009.

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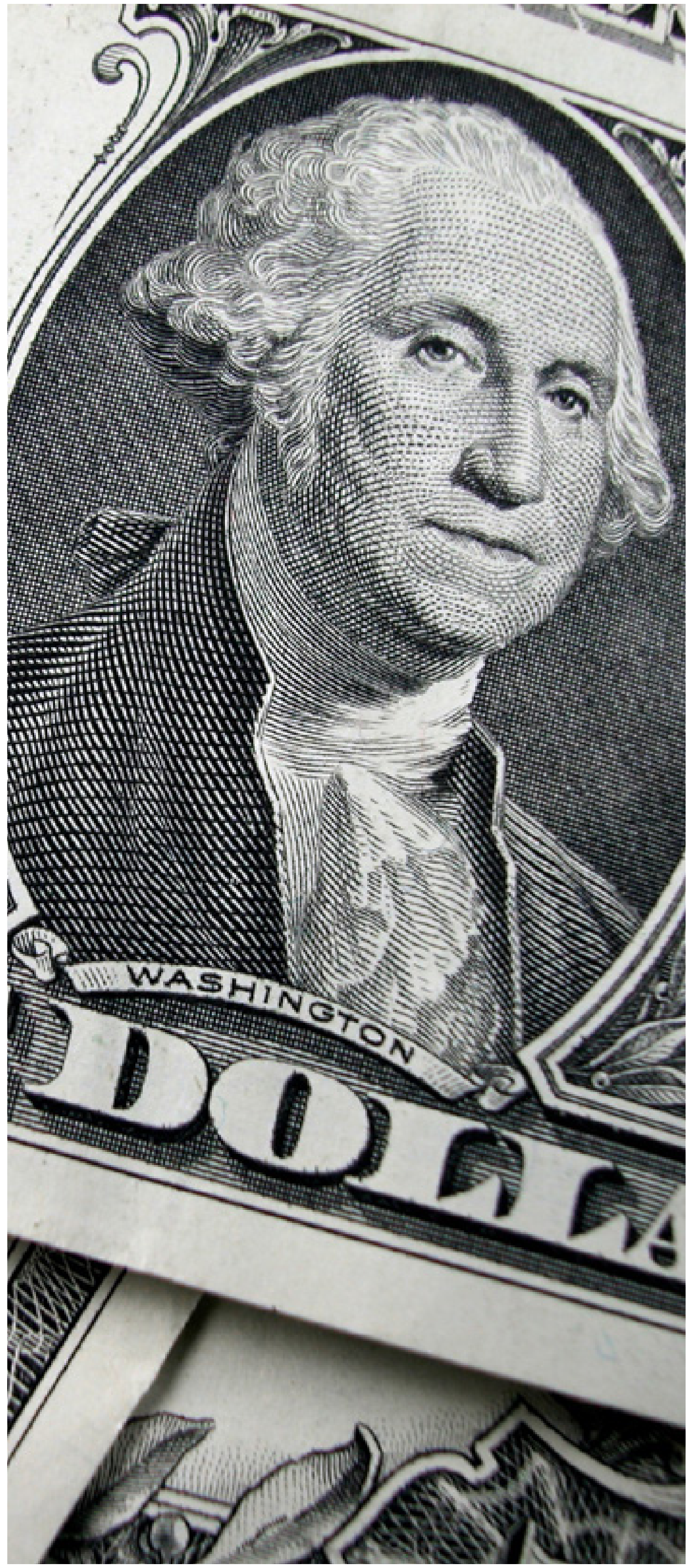

Recent Regulatory and Enforcement Developments
France

France issues guidance regarding external auditors' role enforcing compliance with mandated payment terms

After a near two-year wait, Decree no. 2015-1553 of 27 November 2015, implementing the much awaited provisions of the French Consumer Protection law of 17 March 2014 (hereinafter "The Hamon Law) on payment terms, has finally been adopted. Indeed, this decree, which forms part of the legal arsenal introduced to tackle default and late payments, establishes new reporting obligations as well as obligations to comply with mandatory payment terms. The decree also specifies external auditor's' role in this respect.

A stricter regime for payment terms

Since its promulgation, the Hamon Law has had many implications for businesses in France. In particular, it has established stricter rules on payment terms to prevent financial difficulties for businesses that depend on timely payments to maintain their competitiveness and profitability. Indeed, late or default payments can be highly detrimental to small and medium-sized companies who may, as a result, struggle to obtain short-term financing for their development or even be forced to terminate their activity.

The Hamon Law, which has sought to tackle this issue, now provides that the deadline for payment as agreed between the parties cannot exceed, in France:

- 60 calendar days from the date of issue of the invoice,
- 45 days "end of month", provided that this period be included in the contract and does not manifestly discriminate against the creditor, or
- 45 days from the date of issue of the invoice for periodic invoices.

Non-compliance with these terms results in an administrative fine up to €75,000 for individuals and €375,000 for legal persons, doubled in the case of a repeat offence.

Increased transparency in relation to payment terms

The Hamon Law has aimed to facilitate the detection of offenses by, notably, ensuring that companies whose financial statements are certified by external auditors publish certain information on the payment terms of their suppliers and their customers. However, in practice, the lack of provisions detailing the reporting obligations has undermined these efforts.

With the adoption of Decree no. 2015-1553, this loophole is now mended. Indeed, the implementing text clarifies which information companies must now include in their management reports and details how external auditors are to certify this compliance.

Pursuant to the Decree, companies must specify, on a yearly basis, whether any late or default payments exist with their suppliers and customers. More specifically, they must now identify the number and the amount (excluding VAT) of invoices received from their suppliers, which are not settled by the end of the financial year. Similarly, companies must detail the number and the amount (excluding VAT) of invoices issued to their customers, which have not yet been settled by the end of the financial year.

This decree, relies on external auditors to ensure that the published information is accurate. Indeed, the Decree provides that external auditors must certify the regularity of the information submitted by companies and make sure that it corresponds to their annual accounts. The Decree also requires that external auditors identify any instances in which the company's reports do not correspond to the annual accounts.

These provisions will apply to financial years starting on or after 1 July 2016. A ministerial order is expected to establish the means for presenting the above-mentioned information.

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Recent Regulatory and Enforcement Developments
Mexico

New rules establish which individuals and companies are subject to audits in the Federal District

On 14 January 2016, the Secretary of Treasury (Secretaría de Finanzas) of the Federal District (currently City of Mexico) released the General Rules for Auditing Fulfillment of Tax Obligations Set Forth in the Federal District Tax Code. These rules set forth who, how and when must an audit take place in connection with local taxes in the Mexican capital.

Individuals and companies alike must be audited whenever they fall within any of the following parameters:

A. In case of property tax:
Any party owning non-residential real estate in an amount exceeding $27 million pesos approximately ($1.5 M USD) during 2014.

B. In case of salary tax:
Any party controlling a monthly average of 150+ workers during 2014.
C. Water Supply Tax: Any party demanding more than 500 m3 of water in average per month during 2014.

D. Hospitality Tax:
Any party rendering hospitality services and for which it was paid an amount equal to or exceeding $10,400,000.00 approximately ($577K USD).

Taxpayers falling in any of these categories and meeting these thresholds must submit a notice of obligation to audit through a dedicated website (SIPREDI) on or before 15 March 2016. Auditors will then have to submit the certified report through that same website on or before 31 May 2016.

Failure to submit the notice of obligation to audit or the actual certified report carries a fine for up to $53,349 MXN ($2,884.00 USD approximately) under section 475 subsection VI of the Mexico City's Tax Code.

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Recent Regulatory and Enforcement Developments
The United States

PCAOB approves new rule requiring disclosure of engagement partner

On 15 December 2015, the Public Company Accounting Oversight Board (the PCAOB) unanimously approved a new rule requiring disclosure of the name of the audit engagement partner of any audit of a public company. If approved by the United States Securities and Exchange Commission (the SEC), the rule will require auditing firms to complete and file a new form, "Form AP" with the PCAOB. The form requires firms to provide the name of the relevant audit engagement partner as well as the names of any other firms that participated in that public company audit. Form APs will be due no later than 35 days after the filing of the audit report with the SEC. In the context of initial public offerings, Form AP will be due no later than 10 days after an audit report is included in a filing with the SEC. Copies of completed forms will be publicly available on the PCAOB's website.

The new rule also requires audit firms to assign engagement partners unique identification numbers for disclosure on the Form AP. The purpose of these numbers is to prevent any confusion when engagement partners change or have identical names. Partners that change audit firms will be assigned a new identification number.

The rule change comes after a six-year effort by the PCAOB to add additional disclosures in the audit process. The Board initially advocated inclusion of engagement partner names in audit reports, but that proposal was opposed by many on the ground that it would needlessly subject individuals to liability.

SEC charges accounting firm for failing to retain audit documentation and maintain written policies and procedures regarding the retention of audit materials

On 22 December 2015, the United States Securities and Exchange Commission (SEC) filed and settled charges against a Colorado-based accounting and auditing firm for failure to retain audit files for a number of engagements.

According to the SEC, the firm, Spicer Jeffries LLP (Spicer Jeffries), was unable to produce audit documentation for six of its engagements, all of which were completed for clients that were FINRA registered broker-dealers. During the relevant time period, Spicer Jeffries concluded roughly 350 audits of registered broker-dealers.

The SEC also claimed that the firm lacked sufficient written procedures detailing its retention policies. Although the firm had a written policy mandating that audit files be maintained for six years, it lacked written guidelines that sufficiently outlined the procedures responsible staff should follow to ensure compliance with the retention policy. Spicer Jeffries also did not implement adequate controls to track which personnel had access to stored audit files.

The SEC order—the allegations contained therein were neither admitted nor denied by Spicer Jefferies—provides for a public censure of the firm and requires that Spicer Jeffries retain an independent consultant to help the firm create and implement new written audit documentation retention policies and procedures.

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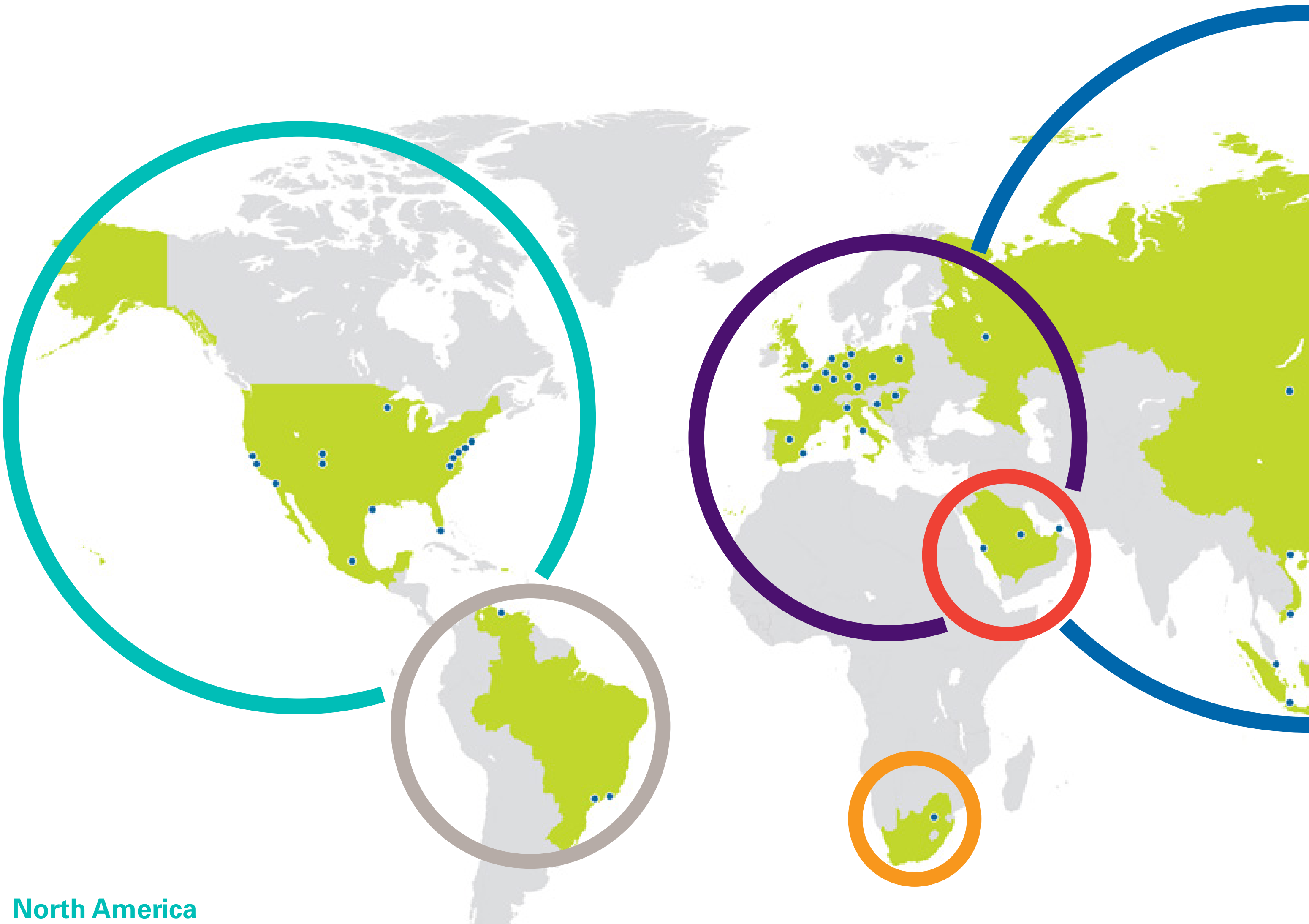

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