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# 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 England/Wales, France, Germany, Italy, Mexico, The Netherlands, 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, Mexico, the Netherlands, and the United States, which are summarized in the pages that follow.

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# Recent Court Decisions

## France

### French appellate court addresses accountant's lien on client documents

On 22 October 2015, the Orléans Court of Appeal addressed the circumstances under which a statutory accountant can place a lien on client documents. In the case at hand, the company sought damages for tax liabilities, which it alleged were caused by the defendant accountant's improper lien on company documents.

The company had outsourced its accounting to the defendant in 2010 and terminated the contractual relationship with the accounting firm on 5 April 2012. The client claimed that the statutory accounting firm had not calculated its financial results for the accounting years 2011 and 2012 but nonetheless demanded payment for its services.

After the contract was terminated, the statutory accounting firm retained the company's invoices and pay slips. Without these documents, the company's new accountant could not file required accounting reports. As a result, it incurred tax penalties.

The court noted that three conditions are necessary for a statutory accountant to enforce a lien.

- **The fees must be actually due to the statutory accountant**. The statutory accountant must be able to prove that he/she has a claim that is certain, of a fixed amount and due. A letter of mission signed by the client could strengthen the legitimacy of the claim.
- **The accounting documents or books withheld must have been created or established by a statutory accountant**. According to case law and to the Statutory Accountants' Commission of Ethics, a lien can be placed only on documents that have been created or partly established by the statutory accountant himself/herself. A lien cannot be enforced on documents belonging to the client or on documents obtained without the client's approval.
- **There must be a connection between the claim and the retained documents**. A lien cannot be applied to: (1) documents created by a third person; (2) documents for which fees have already been paid; and (3) documents unrelated to the unpaid fees.

The court noted that a lien can obstruct the transmission of a file to a subsequent statutory accountant. In order to prevent such obstruction, a statutory accountant requesting payment for fees should first attempt to recover unpaid fees through proceedings before the president of the Regional Council of the Order to which he or she belongs. If such proceedings are unsuccessful, a statutory accountant withholding any documents should:

(1) obtain a court order via summary proceedings for the designation of a registry where the documents can be safely stored and, in parallel,

(2) initiate regular proceedings before the courts to recover outstanding fees.

In the case at hand, the documents withheld by the statutory accounting firm included invoices and pay slips. The court noted that a lien can only be attached to documents created by the statutory accountant and therefore found that this lien was abusive. This decision does not set a new precedent but highlights the fact that statutory accountants' right to withhold documents when awaiting payment of fees is not absolute.

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# Recent Court Decisions

## United States

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**Washington state jury finds Ernst & Young liable for losses in connection with Madoff ponzi scheme**

On 13 November 2015, a Washington state court jury found Ernst & Young LLP (EY) liable to investment manager FutureSelect Portfolio Management, Inc. (FutureSelect) for its losses in connection with EY's audits of certain Madoff feeder funds.

FutureSelect, a Washington state–based investment manager, allegedly invested almost $200 million with the Rye Funds between 1998 and 2008. The Rye Funds, which were managed by Tremont Group Holdings Inc. (Tremont), invested in Bernard L. Madoff Investment Securities LLC (BLMIS). EY audited the Rye Funds from 2000 to 2003. In 2008, it was revealed that Madoff was operating a massive Ponzi scheme through BLMIS. Madoff is currently serving a 150-year prison term for stealing billions of dollars from investors.

In 2010, FutureSelect sued Tremont, its parent companies, EY and Tremont's other auditors[1], alleging that the defendants failed to conduct due diligence on Madoff's operations, violated the Washington State Securities Act (WSSA), and committed negligence and/or negligent misrepresentation.

Regarding EY, FutureSelect claimed that the firm failed to comply with Generally Accepted Auditing Standards because, in conducting its audits of the Rye Funds, EY never verified the existence of assets Madoff claimed to hold; nor did EY verify the purported trades that generated income for Madoff's investors. According to FutureSelect, EY issued unqualified audit opinions for the Rye Funds' financial statements, which constituted direct misrepresentations on which FutureSelect relied in deciding to invest in the Rye Funds. FutureSelect alleged that EY therefore violated the WSSA and negligently misrepresented the financial condition of the funds.

The case against EY proceeded to trial by jury on 15 October 2015[2]. During the month-long trial, FutureSelect argued that EY failed to perform adequate auditing procedures to test the existence of assets on the Rye Funds' financial statements, and instead relied on assurances made by Madoff and Madoff's accounting firm. EY maintained that its auditing procedures were sound and that no one could have detected Madoff's fraud.

On 13 November 2015, the jury found EY liable and awarded FutureSelect $20.3 million in damages. The jury also found that FutureSelect was 50% responsible for its own losses, which reduced the total actual damages to $10.15 million, plus prejudgment interest. The verdict marks the first time a jury has determined that an auditor contributed to the losses suffered by investors with Madoff feeder funds.

FutureSelect Portfolio Management Inc. v. Ernst & Young, 10-2-30732-0, Superior Court of the State of Washington, Kings County (Seattle).

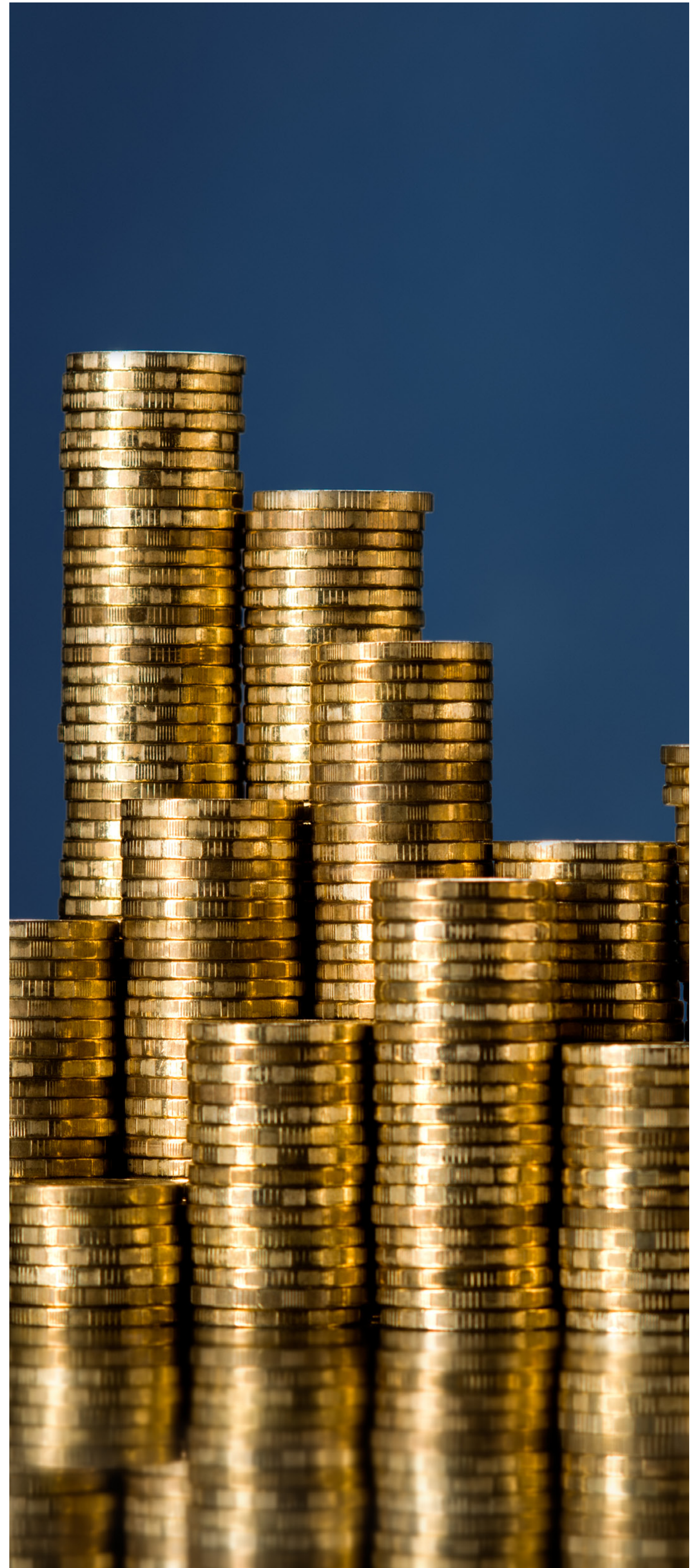
**Northern District of California dismisses securities class action against Baker Tilly and reiterates demanding pleading standards for securities claims**

On 1 October 2015, a California federal judge dismissed a federal securities fraud class action complaint filed against Baker, Tilly, Virchow, & Krause, LLP (Baker Tilly) relating to its audits of Velti plc (Velti). Plaintiffs alleged claims against Baker Tilly under Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 as a result of the alleged material understatement of Velti's bad debt reserves throughout the putative class period, between January 2011 and August 2013. Plaintiffs also sued the Underwriters of certain public offerings of Velti.

[1] The Rye Funds' other auditors included KPMG LLP and Goldstein Golub Kessler.

[2] By this time, the other defendants in the lawsuit had settled with Future-Select, with the exception of KPMG LLP, which arbitrated its claims with FutureSelect pursuant to the court's order.

Velti was a provider of mobile marketing and advertising for businesses around the world. Baker Tilly audited Velti's financial statements for the years ending 2008 through 2012. The financial statements for each of the audit years contained certain disclosures relating to Velti's accounts receivable balances, including its reserves for bad debt. In June 2013, Velti retained Deloitte LLP (Deloitte) to review and evaluate its operations in Greece and Cyprus, with a specific eye to determining the collectability of its receivables in those regions. After two weeks, "with access to the same information available to Baker Tilly," Deloitte presented its initial findings, which were subsequently confirmed in its final report. Deloitte concluded (1) that a "large amount" of Velti's receivables were "very old;" (2) that 85 percent of Velti's $192 million in Greek and Cypriot receivables were attributable to just 26 customers, many of which were affiliated with or related to one another; and (3) that the receivables attributable to these customers were uncollectible. Deloitte recommended that Velti write off approximately $111 million to account for its uncollectible receivables. Velti followed Deloitte's advice, and on 20 August 2013, announced its Q2 2013 financial results and disclosed that it had decided to write off approximately $111 million in receivables. Following these disclosures, Velti shares declined $0.66 per share, or 66 percent, to close on 21 August 2013 at $0.34 per share. Velti's United States-based operations filed for bankruptcy on 4 November 2013, and its European-based operations did the same on 18 August 2014. Plaintiffs filed suit against Baker Tilly, alleging that Baker Tilly certified Velti's reporting of these balances as revenue despite receiving and reviewing reports, as far back as February 2011, showing that Velti's accounts receivable balances were comprised of dangerously aged and overdue balances.



Plaintiffs brought Section 11 claims based on alleged misstatements in Velti's registration statement and prospectus for its initial public offering (IPO), effective 27 January 2011, which included Baker Tilly's 3 August 2010 "Report of Independent Registered Public Accounting Firm" on Velti's 2008 and 2009 financial statements, as well as Velti's registration statement and prospectus for its secondary public offering (SPO), effective 14 June 2011, which included Baker Tilly's 11 April 2011 "Report of Independent Registered Public Accounting Firm" on Velti's

2008, 2009, and 2010 financial statements. Each of the alleged misstatements and omissions was grounded on the basic theory that Velti's bad debt reserves were materially understated in the August 2010 and April 2011 audit reports and accompanying financial statements included in the IPO and SPO registration statements, and that the audit reports and financial statements omitted material information regarding the reserves.

Relying on the U.S. Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), the court dismissed the Section 11 claims against Baker Tilly. The court noted that Baker Tilly's statements relating to Velti's bad debt reserves were statements of opinion and that plaintiffs failed to adequately plead, as required under Omnicare, that those opinions were both "objectively false," i.e., incorrect, and "subjectively false," i.e., not honestly held by Baker Tilly. First, because plaintiffs had specifically alleged that the Section 11 claims were not based on fraud or deception by Baker Tilly (likely in an attempt to avoid the heightened pleading requirements for fraud claims under Federal Rule of Civil Procedure 9(b)), plaintiffs did not contest that Baker Tilly's opinion was honestly held. Moreover, as the court had previously found, the complaint did not contain sufficient factual allegations that the statements regarding Velti's bad debt reserves were objectively false: for example, the complaint did not "identify a single receivable that was in jeopardy of becoming uncollectible when the IPO and SPO registration statements were issued, nor any receivable that existed then and was ultimately written off . . . . Nor do plaintiffs state when and to what extent Velti's reserves should have been increased." Second, to the extent that plaintiffs alleged that the statements regarding Velti's bad debt reserves had omitted certain information, the court held that plaintiffs did not identify any particular, material, omitted fact going to the basis of Baker Tilly's opinions on Velti's bad debt reserves, the omission of which made those opinions misleading.

With respect to the Section 10(b) claims, plaintiffs' claims were based in part on the same alleged misstatements and omissions in Baker Tilly's August 2010 and April 2011 audit reports underlying their Section 11 claims, and in part on alleged misstatements and omissions contained in Velti's annual reports (Forms 20-F) for the years 2010,

2011, and 2012, which each contained Baker Tilly's audit opinion on Velti's financial statements. The court found that to the extent that plaintiffs' Section 10(b) claims were based on Baker Tilly's audit opinions on Velti's 2008 to 2010 financial statements—which were included in the IPO and SPO documents discussed above—the claims failed for the same reasons as plaintiffs' Section 11 claims. The court further held that the Section 10(b) claims also failed to the extent that they were based on Baker Tilly's audit opinions on Velti's 2011 and 2012 financial statements. The court noted that the Private Securities Litigation Reform Act (PSLRA) establishes a heightened pleading standard for the scienter and falsity elements of Section 10(b) claims. In general, plaintiffs "must identify specific contemporaneous statements or conditions that demonstrate the intentional or the deliberately reckless false or misleading nature of the statements when made" to plead falsity and "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind . . . to deceive, manipulate or defraud" to plead scienter. The court found that those claims based on Baker Tilly's opinions on Velti's 2011 and 2012 financial statements failed because merely pleading that bad debt reserves turned out to be inadequate is not enough to state a claim for allegedly misstating bad debt reserves under Rule 9(b) and the PSLRA. Plaintiffs failed to allege facts indicating that Baker Tilly intentionally or knowingly falsified the financial statements, knew or must have known that the reserves were materially misstated, or conducted an audit that was such an extreme departure from reasonable accounting practice that it knew or had to have known that its conclusions would mislead investors.

The court found that plaintiffs also failed to establish standing and loss causation. One plaintiff had sold its shares before the disclosure of the $111 million write-off, meaning that any losses it suffered could not have been caused by the alleged misstatements leading to the write-off. Defendants therefore had a valid negative causation defense against any claims that plaintiff made. Another plaintiff had its claims dismissed because it had not submitted a 77z-1(a)(2)(A) certification as required for class representatives in securities class actions.

**Settlement between Parmalat and Grant Thornton**

On 30 October 2015, Parmalat S.p.A. and the Extraordinary Commissioner of the former Parmalat Group companies (Parmalat) reached a settlement with Grant Thornton International Inc., Grant Thornton International Ltd., and Grant Thornton LLP (collectively, "Grant Thornton") in relation to an action filed by Parmalat against Grant Thornton relating to Grant Thornton's audits of Parmalat.

The lawsuit, commenced in 2004 by the Extraordinary Commissioner of Parmalat, concerned the audit activities performed by the Italian firm then known as Grant Thornton S.p.A.—a member firm of Grant Thornton International Inc.—in the period before the former Parmalat Group declared bankruptcy. It also asserted claims against Deloitte Touche Tohmatsu and several related entities, which were settled in 2007. The lawsuit sought roughly US $10 billion in damages.

The lawsuit, which alleged that Grant Thornton knew of the accounting fraud that led to Parmalat's insolvency in 2003, was initially dismissed by the U.S. District Court for the Southern District of New York, and later by the U.S. District Court for the Northern District of Illinois. After appeals relating to jurisdictional issues, it was transferred to Cook County, Illinois, where it was dismissed in March 2015. The Extraordinary Commissioner appealed that dismissal.

This settlement provides a US $4.4 million payment by Grant Thornton International Inc. to Parmalat and includes the parties' agreement that neither the settlement nor the payment may be construed as an admission of liability. In addition, the settlement fully and finally releases Grant Thornton International Inc., Grant Thornton International Ltd., and Grant Thornton LLP. The settlement precludes any present or future claim or finding of any nature against Grant Thornton International, Inc., Grant Thornton International Ltd., or Grant Thornton LLP in any case related to the issues arising from the mentioned activities or litigation proceedings.

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# Recent Regulatory and Enforcement Developments

## The Netherlands

### External auditor disciplined for issuing unqualified opinion prior to bank's bankruptcy

On 18 November 2015 the Commission for Appeal ruled to discipline an auditor who issued an unqualified opinion on a bank's 2008 financial statements prior to the bank filing for bankruptcy in 2009. The Netherlands Authority for the Financial Markets (AFM) subsequently investigated the causes of the bankruptcy. Based on the results of that investigation, AFM filed a complaint against the auditor. The complaint asserts that he:

(a) failed to recognize problems regarding the continuance of the assignment;

(b) failed to recognize certain control risks;

(c) failed to receive sufficient control information to substantiate his unqualified opinion relating to:

  (i) the balance account regarding lending/credit;

  (ii) the valuation of claims against an affiliated company.

The complaint also alleged that the accountant failed to consider the impact of circumstances, such as the credit crunch, changes in the board of the bank and the impact of stories in the media. The AFM thus claimed that the auditor's unqualified opinion was not sufficiently supported.

**Chamber of Accountants**

The Chamber of Accountants ruled in the first instance that there was no reason to believe that the accountant should have ended his assignment at the bank. It found that the complaint did not sufficiently allege circumstances that harmed the integrity or independence of the accountant. Also, it was not clear to the Chamber of Accountants that the accountant should have determined that he could not properly complete the assignment given those circumstances.

However, the Chamber of Accountants did rule that the auditor failed to properly evaluate the lending balance account. This assessment led to a formal reprimand against the accountant.

**Commission for Appeal for Business and Industry**

On appeal, the Commission for Appeal issued a more severe disciplinary sanction, removing the auditor from the register for six months. It specifically reasoned that:

(a) The accountant failed to sufficiently consider the special circumstances the bank was in and failed to recognize important circumstances that impacted whether he should have continued in the assignment.

(b) The auditor was also negligent in recognizing certain control risks.

(c) The accountant did not meet the high demands of controls in respect to the lending balance account. The control of this balance account was even more important as it represented 86,6% of the total balance sheet.

(d) Finally, a relationship between the bank and an affiliated company was not assessed thoroughly. The  Commission noted a discrepancy between the value of the claims against the affiliated company on the bank's balance sheet and the accounting at the affiliated company.

Thus, the Commission concluded that the auditor's work lacked depth and professionalism because he executed the audit with insufficient control information.

**Conclusion**

It is not surprising that the AFM investigated the causes of the bank's bankruptcy, which had a broad impact. The disciplinary action that followed underscores that high risk audits can create reputational risks, as well as the importance of identifying material deviations in the balance sheet and comparing the accounting treatment of transactions between group companies.

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# Recent Regulatory and Enforcement Developments
Mexico

## Mexican Supreme Court rules tax code provisions are constitutional

**Background**

Article 69-B of the Federal Tax Code sets forth that when the tax authority detects that a taxpayer has issued invoices without having assets, employees, infrastructure or material capacity to render the referenced services or products, "the authority will presume the non-existence of the operations referred in such invoices". In other words, if a taxpayer issues invoices for services or products it cannot provide, the tax authority assumes that the invoice does not exist.

In such cases, the tax authority notifies taxpayers of the determination through electronic mail and in the Official Gazette. The effect of these notices is that the operations referenced in the tax notice, are not valid for taxation purposes. This impacts both the party that issued the disallowed invoice and the party receiving it.

The issuing party will not be able to accrue the amount invoiced as income and the receiving party will not be able to deduct amounts paid as expenses. Thus, both parties will have inconsistencies in their tax records. If either party to the allegedly non-existent transaction were audited, the tax authorities are empowered to speculate on the amounts not supported by a valid invoice and impose hefty tax penalties for the speculative calculation. In some cases, these infringements could even carry a prison sentence for individuals involved.

**October's Update**

In light of this, taxpayers initiated *amparo* (constitutional challenges) proceedings seeking a declaration of unconstitutionality of section 69-B. They argued primarily that this provision violates the freedom of commerce, presumption of innocence, right to be heard and the prohibition of retroactive application of law. On 23 October 2015, the Second Chamber of the Mexican Supreme Court issued four binding precedents (1,2,3,4) (jurisprudencias) rejecting the taxpayers' arguments and declaring article 69-B constitutional.

The Supreme Court reasoned that treating a transaction as non-existent does not prevent taxpayers from conducting commercial activities. Moreover, because the presumption can be overturned with sufficient evidence, the court concluded it neither contravenes the presumption of innocence nor deprives the taxpayer from the right to be heard.

The court noted that companies must be aware of whom they are dealing with and the possible consequences that such dealings may have. The underlying intention of the tax rule is to build a collective conscience of the negative consequences of disregarding the law; especially in tax matters.

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