Hogan Lovells

Global Accountants' Liability Update

Contents

MARCH 2015

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, Hong Kong, Italy, Mexico, the Netherlands, Russia, Singapore, 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 England, France, Mexico, the Netherlands, Spain, and the United States, which are summarized in the pages that follow.

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England

Claim against auditors thrown out due to valid disclaimer of responsibility

Barclays Bank Plc v Grant Thornton UK LLP [2015] EWHC 320 (Comm)

In February 2015 the High Court awarded summary judgment to a defendant auditor, Grant Thornton (GT), holding that a disclaimer in an audit report stating that the auditor assumes no responsibility to third parties bars any liability to a third party claiming to have relied on the audit report, even when such reliance was foreseeable. Notably, this was the first case in which an English or Welsh court considered the legality of the Institute of Chartered Accountants of England and Wales' standard disclaimer clause (known as a Bannerman Clause).

In this case, Barclays brought a negligence claim against GT, asserting that it had relied on GT's non-statutory audit reports relating to a luxury hotel company when making the decision to extend a loan facility to the company. Barclays further claimed that GT negligently failed to uncover a fraud within the company, which resulted in an artificial inflation of its financial performance. The company subsequently went into liquidation, causing loss to Barclays.

The key issue in the case was the effectiveness of a disclaimer clause in the audit reports. GT had been engaged by the company — not by Barclays. GT's disclaimer expressly stated that the reports were prepared solely for the company's director and that GT did not accept or assume responsibility to anyone other than the company and its director. The court held that the GT disclaimer, which followed the standard wording (with some minor amendments) of the Bannerman Clause, was effective in precluding any duty of care to Barclays, even in circumstances where GT knew Barclays was relying on its audit opinions.

The court's analysis did not turn on whether GT was aware that Barclays was likely to rely on its audits, or that such reliance was intended by the luxury hotel company. Rather, the court held that the disclaimer negated any duty of care that would otherwise exist as long as it complied with a statutory reasonableness requirement. With regards to the reasonableness of the disclaimer, Barclays alleged that the Bannerman Clause was not brought to their attention. However, the clauses were the first two paragraphs in an eight paragraph report. The court concluded that the disclaimer clause would have been clear and easily understandable to any reader who considered the first two paragraphs of the short reports. The court further held that even if GT had known that Barclays would rely on its audit reports, it was not unreasonable for GT to incorporate a disclaimer clause that would preclude a duty of care to Barclays. The court reasoned that because both parties were sophisticated commercial parties, Barclays should know that auditors limit their liability through standard clauses and should have noted during their previous dealings with GT that they sought to limit liability arising from their reports.

This decision is consistent with U.S. cases that have held that express disclaimers in a contract for tax services (*Tredennick v. Bone*, 647 F. Supp. 2d 495, 499-502 (W.D. Pa. 2007), aff'd, 323 F. App'x 103 (3d Cir. 2008)) and in an audit report (*Ellis v. Grant Thornton LLP*, 530 F.3d 280, 289 (4th Cir. 2008)) precluded claims of reliance on the reports by third parties.

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France

The French Supreme Court provides further guidance on conditions that warrant dismissal of external auditors

On 10 February 2015, the French Supreme Court handed down a decision relating to the dismissal of an external auditor. Since the Financial Security Act was passed in 2003, the status of external auditors is strictly controlled and the conditions of their dismissal are specified in Article L. 823-7 of the French Commercial Code. It establishes that the following people may request the dismissal of external auditors

- members of the Board of Directors;
- members of the management;
- shareholders or partners, individually or collectively, representing at least 5% of the share capital;
- the works council; and
- the public prosecutor.

The Supreme Court decision involved the dismissal of Numatic International's external auditor. Numatic International asserted that the external auditor's dismissal was warranted because

- he failed to spot a misappropriation of €1 million that occurred at the beginning of his mission;
- he had a personal relationship with the CEO, which is unlawful under the Financial Security Act;
- he reported several accounting irregularities to the Public Prosecutor (this action was eventually found to be unnecessary and damaging to the company); and

- he refused to authenticate the company's accounts without providing any details or comprehensive explanations as to the reasons of this refusal.

The auditor argued that he was unlawfully dismissed because he was summoned to his dismissal by the company itself, which does not have authority to dismiss auditors under Article L. 823-7 of the French Commercial Code. In a 13 June 2013 opinion, the Paris Court of Appeal rejected this argument and ruled that the company lawfully dismissed the external auditor. The auditor subsequently appealed to the French Supreme Court.

On 10 February 2015, the French Supreme Court reversed the Court of Appeal decision. The Supreme Court ruled that Numatic International's dismissal of its external auditor was unlawful because the French Commercial Code does not entitle a company, as a legal entity, to dismiss an external auditor.

The French Supreme Court was silent on an interesting issue that was at the heart of the decision handed down by the Paris Court of Appeal: were the mistakes committed by the external auditor sufficient to justify his dismissal? According to the French Commercial Code, an external auditor can be dismissed on the ground of a "fault." The Code does not define "fault" and French courts have applied this standard inconsistently. Some courts have found dismissal of an auditor lawful if

- the auditor did not carry out a thorough audit of the company's accounts: in that case, the company is not required to demonstrate the bad faith of the auditor and the classic concept of fault that arises from civil liability applies; or

- the audit procedures carried out by the auditor were excessive (e.g. an unnecessary warning of the Public Prosecutor): in that case, the company is required to demonstrate the bad faith of the auditor.

In the Paris Court of Appeal, the external auditor's counsel had argued that the auditors can be dismissed for "fault" only with a showing bad faith. The Paris Court of Appeal disagreed and found that the auditor's decision to warn the Public Prosecutor was excessive, even without evidence of his bad faith.

However, the Supreme Court based its decision solely on the procedural issue and did not reach the substantive issue decided by the Paris Court of Appeal. If the French Supreme Court's decision had not been based on a procedural ground, this case would have been a good opportunity for the court to provide needed guidance to lower courts regarding the nature of the fault required to justify the dismissal of an auditor.

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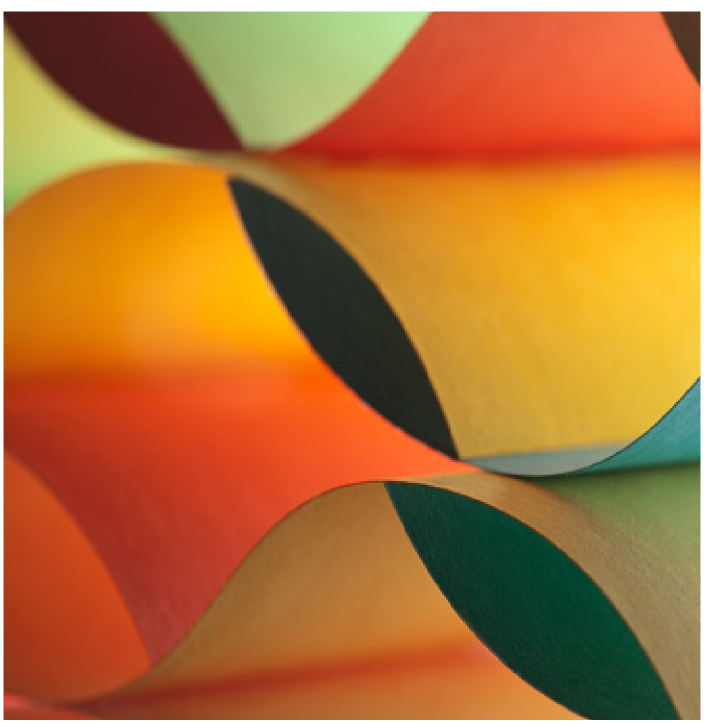
Mexico

Supreme Court authorizes stays in actions challenging e-accounting requirements

Background
As we reported in our November 2014 Update, many important amendments to the Federal Tax Code came into effect in July 2014. One of the most important changes was the so called "e-accounting" requirement set forth in article 28 of the Federal Tax Code. This provision requires individuals and companies to record and process their financial information by electronic means only and upload financial information to a government data base on a monthly basis.

Businesses have objected to this new requirement because, among other things, compliance requires businesses to incur additional expenses for software, hardware, staff, training, maintenance, etc. Individuals and businesses alike challenged the amendments through thousands of amparo requests (constitutional challenge). Most petitioners requested stay orders relieving them of their obligation to upload accounting records on a monthly basis. Nevertheless, the Federal Circuit Collegiate Courts issued a binding precedent indicating that stay orders could not be granted as requested because granting them would hamper the efficiency of tax enforcement proceedings thus affecting the collective interest intrinsic to the state's activities.



In November 2014, we opined that this decision effectively mooted the challenges to the e-accounting requirement because it compelled business to incur the very expenses they were trying to avoid by challenging the rules.

February development
On 13 February 2015, the Mexican Supreme Court issued a new binding precedent establishing that the stay orders must be granted in the amparo proceeding against the "e-accounting" amendment. The Supreme Court reasoned that, although the amendments seek to speed tax collection, granting the stay order does not prevent individuals and companies from making timely tax payments. This is so because taxpayers may file their accounting documents in paper form while a stay is in effect.

The new binding precedent issued by the Supreme Court repeals the decision issued by the Federal Circuit Collegiate Courts. Therefore, amparo petitioners that challenge the "e-accounting" amendment will be granted with a stay order (if requested), and consequently they won't be compelled to upload their accounting records on a monthly basis until the constitutionality of the amendment is finally determined through the amparo procedure. If the "e-accounting" provisions are ultimately declared constitutional, individuals and companies will then be required keep their financial information by electronic means and upload it to the governmental data base on a monthly basis. Those that fail to do so will face a fine of up to MXN$25,000 in accordance with article 82 of the Federal Tax Code.

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The Netherlands

Recent decision creates confusion regarding scope of accountants' obligations to report suspected fraud

Last month, we reported on the 23 January 2015 decision of the Accountancy Division addressing an accountant's confidentiality obligation. In that decision, the Accountancy Division ruled that the accountant in question should have reported its client's tax fraud to tax authorities thereby breaching its confidentiality obligation. Considering the substantial amount of the fraud, the court concluded that the public's interest in discovering the fraud promptly justified the breach of confidentiality.

Several media sources reported on this decision and a recent article in the Dutch Financial Journal (Financieel Dagblad) dated 19 February 2015 highlights the public debate the decision has prompted. Some commentators have applauded the decision because it prevents clients from exploiting an accountant's confidentiality obligation to support fraud. In contrast, the Dutch Financial Journal article asserts that the decision creates uncertainty about accountants' disclosure and confidentiality obligation.

Prior to the Accountancy Division's decision, accountants had an obligation to report unusual transactions and suspected fraud to the Dutch Financial Intelligence Unit (the FIU). There was, however, no legal obligation to report to tax authorities and confidentiality obligations therefore prevented such reporting. The Dutch Financial Journal article asserts that, by imposing an obligation to report to tax authorities, the Accountancy Division has indicated that the FIU reporting obligation is insufficient to combat fraud.

The Accountancy Division's decision requires a report to tax authorities when there is 'substantial' fraud. The lower limit of this reporting obligation is not clear. The Dutch Financial Journal article thus calls for legislation clarifying the parameters of this new reporting obligation.

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Spain

Spain debates specifics in draft audit act

Draft audit act submitted to Parliament
As we have previously reported, a draft Audit Act, which would enhance the quality of Spanish audit reports and conform Spanish law to European law, is progressing through Spain's Parliamentary system. The Spanish Council of Ministers has now forwarded the draft Audit Act to Parliament for approval by the end of the Parliamentary term prior to 20 December 2015.

As approved by Spain's Council of Ministers, the draft Audit Act establishes a ten year maximum term for audit appointments but allows for an additional four year renewal where the audit is performed jointly by two separate audit firms. This maximum audit engagement term is shorter than the 20 year term permitted under EU regulation.

The Draft Act also aims to strengthen the independence of auditors by identifying certain incompatible activities that auditors are prohibited from performing for a company they are auditing (legal services for such company is one of several prohibited activities).

Big four accounting firms push for ICAC autonomy
Deloitte, EY, KPMG, and PwC have requested that the draft Audit Act be amended to ensure the independence of the regulatory agency, the Spanish Institute of Accountants and Auditors (ICAC). This request was supported by Spain's Council of State, the supreme consultative council of the Government, which voiced concern over language in the draft act that places the ICAC under the supervision of the Ministry of Economy. The Ministers Council, however, declined to amend the draft Act to address this concern. The Big Four accounting firms are therefore now requesting that Parliament address their concern.

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United States

Second Circuit finds investors in Madoff feeder fund could not hold fund's auditors liable

The Second Circuit Court of Appeals held in February that an auditor is not liable to third-party users of the auditor's reports where the auditor failed to uncover fraud in the audited fund's underlying investments.

Plaintiffs in the case were trustees of a pension fund called Empire State Carpenters Welfare, Annuity, and Pension Funds (collectively, Empire), which had invested millions of dollars in Beacon Associates LLC and related funds (collectively, Beacon). Beacon, in turn, invested a large majority of its assets in Bernard L. Madoff Investment Securities LLC (BLMIS). Plaintiffs alleged that Friedberg, Smith & Co., P.C. (Friedberg), which served as independent auditor for Beacon, failed to uncover Madoff's fraud because it did not obtain sufficient information from BLMIS to "verify the existence, accuracy, and value of Beacon's BLMIS investments."

The Second Circuit Court of Appeals affirmed the District Court's dismissal of Empire's complaint against Friedberg. *DeLollis v. Friedberg, Smith & Co., P.C.*, — Fed. App'x. — , 2015 WL 509629 (2d Cir. 2015). The Second Circuit held that Empire's claim improperly imposed on Friedberg a duty to audit BLMIS, "a non-client third party." To hold for the plaintiffs, according to the court, would create "the untenable situation where auditors would be required to audit every company in which its audit client has invested." The court found that no such obligations existed under Generally Accepted Auditing Standards.

The court also found the identity of the third party, BLMIS, to be "particularly important," given that Madoff was notorious for concealing his fraud from sophisticated entities, including the SEC. Additionally, as the court noted, numerous actions against auditors and investment advisors by victims of Madoff's fraud have been dismissed by other courts, "despite the presence of 'red flags.'" Id. If actions against auditors who simply ignored warning signs cannot be sustained, said the court, then surely an auditor like Friedberg could not be held to have violated a duty to "discover the red flags in the first place."

FASB/IASB Joint Revenue Recognition Standard raises questions that create divergence

More than nine months after the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) released revised standards on revenue recognition, efforts to implement those standards have raised questions.

FASB and IASB released a converged revenue recognition standard in May 2014 after six years of discussion, public comment, and board review. The goal of the convergence was to standardize how companies should recognize revenue from customer contracts under both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). According to the May 2014 issuance, companies using GAAP in the US will be required to apply the new standards for annual reporting periods beginning after 15 December 2016, while those companies using IFRS will have until reporting periods beginning on 1 January 2017 to start using the new standards.

Though the two standard-setting bodies billed the new revenue recognition rules as "converged," they may not remain uniform for long. The FASB and IASB will each propose guidance on the new revenue recognition standard in order to address "[i]mplementation questions from numerous preparers." In answering these questions, the two entities "came to different conclusions on the substance of some of the clarifying changes and revisions they plan to propose." This parallel but separate guidance will likely cause the revenue recognition rules in the United States to diverge somewhat from those applied abroad. Citing the FASB's statements, the Journal of Accountancy identifies intellectual property licenses and identification of performance obligations as areas in which FASB and IASB rules will differ. It appears that even the effective date of the standard is now an area of dispute, with the FASB considering a delay due to the new proposed guidance, while the IASB claims it does not find delay particularly necessary.

A decision on the effective date is expected to be released this March.

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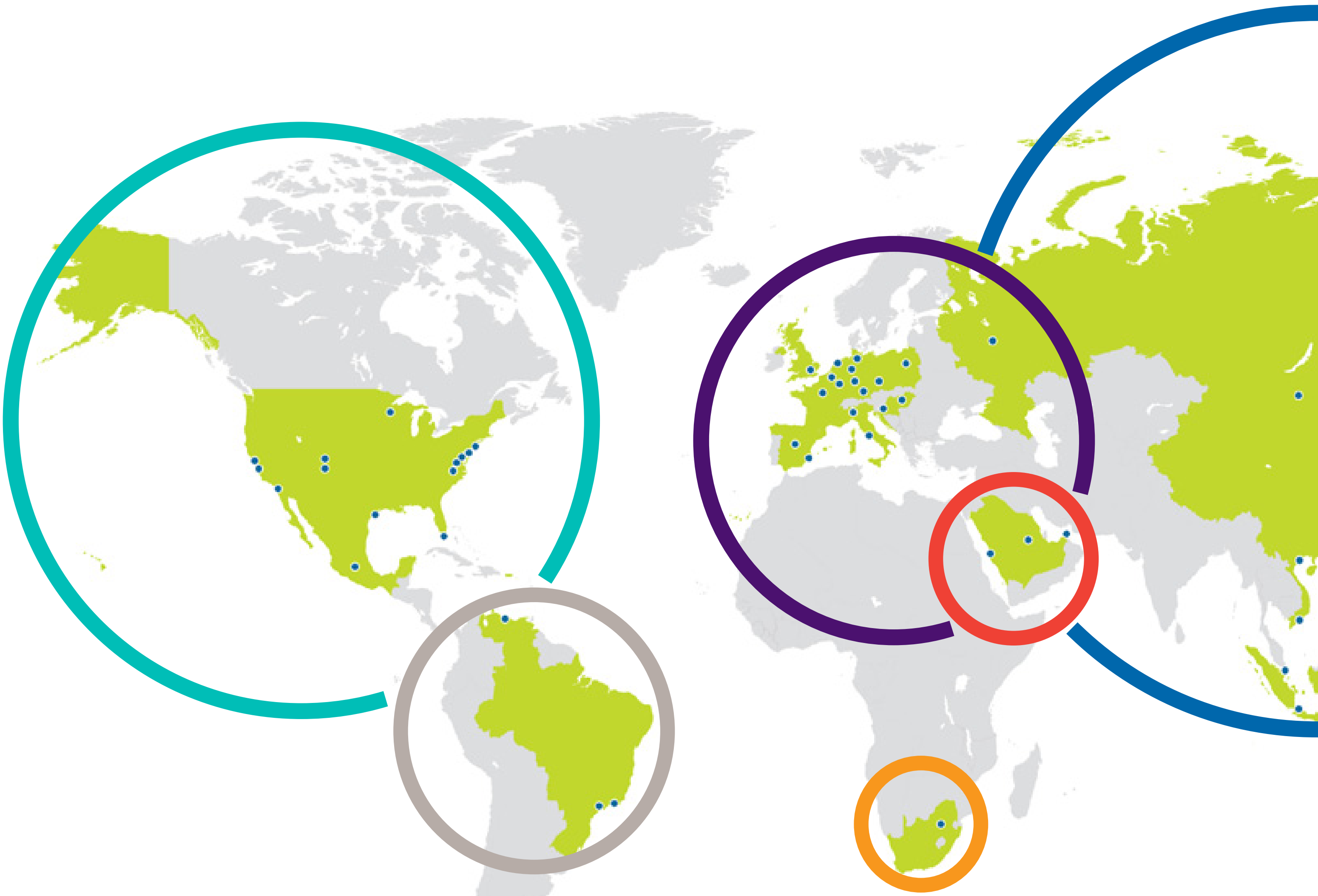

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