Hogan Lovells

Our Global Accountants' Liability Update

June 2019

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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. 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. We recently identified developments of interest in Hong Kong, The Netherlands, and The United States, which are summarized in the pages that follow.

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Recent court decisions

The Netherlands

Supreme Court judgment on accountant's duty of care

On 17 May 2019, the Dutch Supreme Court held EY liable for the damages suffered by the general manager (GM) who was dismissed after EY audited the GM's practices. The EY audit, performed at the request of the board of a foundation, reported that the GM had engaged in several accounting irregularities. EY concluded that the GM had sent false invoices concerning travel and representation expenses and, following the audit, the board dismissed the GM.

The GM disputed EY's conclusions and sought damages he suffered as a result of the dismissal. He alleged that EY did not provide him with a copy of the complete audit before sending it to the board thus depriving him of his right to a fair hearing. On this basis, the GM argued that EY had breached its duty of care towards him.

Subject of appeal

The Dutch Act on Accountancy Firms requires the Association of accountancy firms to adopt rules of conduct for the profession. Among other things, these rules require that auditors take the interests of the subject of an audit into account when their position is being investigated. In this case, the GM was the subject of the audit. The question before the court was whether EY's obligation to take the GM's interest into account required that EY involve the GM in the process of the audit and whether EY should have given him the opportunity to respond to the report *before* sending it to the board.

Judgment

The Dutch Supreme Court confirmed that given the aim of the audit – to determine whether the GM had abused his position and had stolen money from the foundation – EY had a duty to take the GM's interests into consideration when preparing the report. In addition, the Court ruled that the rules of conduct were not drafted to solely protect the interests of the accountant's clients but also to protect the interests of other stakeholders, such as the GM in this case.

The Supreme Court noted that the rules of conduct required EY to respect the GM's right to a fair hearing. In this case, this means that EY should have given the GM prior access to the report, before sending it to the board. The court explained that this would have enabled the GM to discuss the report with his own lawyer or accountant and prepare a response. Because EY failed to do so, it violated the principles of a fair hearing and thus the Court held that EY had breached its duty of care and was liable for the GM's damages.

Conclusion

The rules of conduct for accountants are not limited to their relationships with their clients. Accountants should consider what steps may be necessary in order to take the interests of stakeholders into account when carrying out an assignment. This decision makes it clear that an accountant's duty of care requires that he or she send an audit report to any individual who is the subject of the audit, before finalizing the report. Accountants who fail to do so could be held liable for the damages suffered by the subject of the audit.

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Recent regulatory and enforcement developments

Hong Kong

Proposed rule changes on disclaimers and adverse audit opinions

On 24 May 2019, the Hong Kong Stock Exchange published the conclusions of its consultation process with respect to proposed changes to the Listing Rules relating to disclaimers and adverse audit opinions in issuer's financial statements. A complete copy of the conclusion is available here.

Most significantly, the new proposed Listing Rule 13.50A will "normally require" the suspension of trading in a security when the auditor has given (or has indicated that it will give) a disclaimer or adverse opinion with respect to published preliminary annual results for financial years commencing on or after 1 January 2019.

Any suspension will usually remain in force until:

1. The listed issuer has remedied the underlying issue giving rise to auditor's disclaimer or adverse opinion;
2. The listed issuer has published financial information to accurately reflect its updated position so as to enable investors to make an informed assessment of its finances; and
3. The auditor has provided comfort that the disclaimer or adverse opinion has been removed.

The Exchange may disregard the suspension requirement where (i) the disclaimer or adverse opinion relates solely to a going concern; or (ii) the underlying issues giving rise to the audit modification have been resolved before the issuer publishes its preliminary annual results.

Where the resolution of issues giving rise to the disclaimer or adverse opinion is outside the issuer's control, a longer remedial period may be allowed with the duration of the period being determined on a case by case basis. As a transitional arrangement, the remedial period will be extended to 24 months for both Main Board and GEM issuers that are suspended solely due to a disclaimer or adverse opinion on the issuers' financial statements for the financial years commencing between 1 September 2019 and 31 August 2021.

The FRC said in a statement that it "*firmly believes that high quality auditing by auditors and reliable financial reporting by issuers combined play a pivotal role in protecting investors' interest.*"

The new Listing Rule will apply to issuers' preliminary annual results announcements for financial years commencing on or after 1 September 2019.

Date given for implementation of new regulatory regime for auditors

1 October 2019, has been announced as the date that direct powers of inspection, investigation, and also disciplinary power over auditors of listed companies will be transferred from the Hong Kong Institute of Public Accountants (HKICPA) to the Financial Reporting Counsel (FRC). The full announcement is available here.

While all regulatory powers related to auditors of listed companies will transfer to the FRC, the

HKICPA will retain responsibility for the registration, training, auditing and maintenance of professional ethics, albeit under the supervision of the FRC.

The changes are designed to bring Hong Kong in line with global best practice.

Two senior officers of listed companies penalised

In May 2019, the Discipline Committee of the HKICPA sanctioned two senior officers of listed companies for professional behaviour breaches contrary to the Code of Ethics for Professional Accountants.

The Discipline Committee ordered that the former Chairman of a financial services provider be removed from the register of CPAs for 2 years with effect from 24 May 2019. The order was made after the Hong Kong Court of First Instance made orders in 2015, disqualifying the officer from being a director involved in the management of any listed or unlisted corporation in Hong Kong for four years. The court found that he had falsely put forward a non-existent agreement between the company and a third party for the distribution of dividends in connection with an acquisition undertaken by the company. The Disciplinary Committee commented that a breach of trust by a fiduciary is a very serious matter and the amount involved was material.

In the second case, the Disciplinary Committee investigated after the Market Misconduct Tribunal found that the financial controller, company secretary and compliance officer of an investment holding company had been reckless in failing to ensure the company's timely disclosure of deteriorating financial performance in late 2012 and early 2013. The committee ordered that the controller's name be removed from the register of CPAs for 12 months with effect from 13 May 2019 for conduct that amounted to a serious breach of statutory duties and the trust and confidence placed on him by the public and shareholders alike.

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The United States

PwC to pay over US$335M in FDIC settlement related to Colonial Bank audits

On 15 March 2019 the Federal Deposit Insurance Corporation announced a settlement agreement with PricewaterhouseCoopers (PwC), pursuant to which the Big Four firm will pay US$335 million to dispose of professional negligence claims levied against it in connection with its past audits of the failed, Alabama-based Colonial Bank.

Prior to the financial crisis, Colonial Bank funded many of the mortgages originated by Taylor, Bean & Whitaker (TBW), the largest privately held mortgage company in the United States at the time. TBW, notorious for its role in the crisis, originated, serviced, and sold those Colonial Bank-funded and other mortgages to Freddie Mac and Fannie Mae. TBW collapsed in 2009 following the discovery that it's Chairman, Lee Farkas, and others falsified TBW's books for years to cover up hundreds of millions in fictitious mortgages.

From 2002 to 2009, Farkas and other conspirators shuttled funds between accounts at Colonial Bank and Ocala Funding, a TBW subsidiary that also provided funding for the company's mortgages to cover its constant overdrafts.[1] That constant overdraft exceeded US$120 million by the end of 2003 and, as the fraud became increasingly complex, Farkas and others began selling fraudulent mortgages to cover the shortage.[2] When TBW collapsed, Colonial Bank followed suit, with US$25.5 billion in assets, over US$500 million in non-existent loans on its books, and losses to the FDIC's Deposit Insurance Fund of nearly US$3 billion. The FDIC was appointed receiver for the bank.

The FDIC brought suit against PwC for its role auditing Colonial Bank prior to its collapse, claiming the bank's collapse cost the insurer US$5 billion and alleging PwC's professional negligence in failing to identify long-running fraud between the bank and TBW.[3] Specifically, the FDIC faulted PwC for allowing Colonial to account for certain transactions as sales of mortgages from TBW to Colonial, rather than as loans from Colonial to TBW that were secured by mortgages. The Colonial Bank bankruptcy trustee also brought professional negligence and breach of contract claims against PwC.[4]

After a month-long bench trial on liability, U.S. District Judge Barbara Jacobs Rothstein agreed with the FDIC's negligence allegation, holding that PwC "did not design its audits to detect fraud" and that its "failure to do so constitutes a violation of the auditing standards."[5] Judge Rothstein, however, rejected the Colonial trustee's negligence claims as barred by the *in pari delicto* doctrine, the Hinke rule, and the audit interference rule on account of Colonial Bank's own wrongdoing, and dismissed the trustee's breach of contract claims.[6] Following a later trial on damages, Judge Rothstein ordered that PwC pay US$625 million in damages to the FDIC. [7]

PwC's US$335 million settlement with the FDIC fully disposes of the FDIC's suit, and comes in well below Judge Rothstein's earlier damages award. The terms of the settlement contain no admissions of liability by PwC. Notably, FDIC Board Member Martin Gruenberg issued a statement voicing his dissent to the settlement because the settlement did not include a written admission of liability by PwC.

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1. *See* Order on the Liability Phase of the PwC Bench Trial, ECF No. 798 (dated December 28, 2017) at 10.
2. *Id.* at 10-11.
3. *Id.* at 12.
4. *Id.*
5. *Id.* at 29.
6. *See Id.* at 79, 91.
7. *See* Order on the Damages Phase of the PwC Bench Trial, ECF No. 875 (dated July 2, 2018) at 3, 24.

PCAOB censure of big four firm's Colombia outfit affirms board's interest in disciplinary proceedings outside the United States

On 16 March 2019, the PCAOB issued an order censuring Deloitte & Touche Ltda. (DT Colombia) and imposing civil penalties for the firm's failure to timely report its involvement in disciplinary proceedings administered by Colombian authorities.

DT Colombia, a member of the global Deloitte Touche Tohmatsu Limited network, is a limited liability company organized under Colombian law and headquartered in Bogota. The firm is licensed in Colombia by the Junta Central de Contadores, part of the Colombian Ministry of Commerce, Industry and Tourism. In its order, the PCAOB noted the JCC qualifies as a "foreign auditor oversight authority" under PCAOB Rule 1001(f)(iii), as a governmental body empowered to conduct inspections of public accounting firms and to administer or enforce laws regulating the same. DT Colombia is registered with the PCAOB pursuant Section 102 of the Sarbanes-Oxley Act and PCAOB rules.

Firms registered with the PCAOB are subject to certain reporting obligations under PCAOB Rule 2203, *Special Reports*. That rule requires registered public accounting firms to file a special report to the PCAOB on Form 3 reporting any event specified within Item 2.7 of that form within 30 days of the event's occurrence. Item 2.7's specified events include when a firm "has become aware that," in a matter arising out of the Firm's provision of professional services to its client, it "has become a defendant or respondent" in civil proceedings or alternative dispute resolution initiated by a governmental entity, or in an administrative or disciplinary proceeding other than those initiated by the PCAOB itself. The specified events requiring a special report under Rule 2023 also include when a firm "has become aware that" an Item 2.7 proceeding "has been concluded."

Between August 2014 and October 2016, the JCC initiated seven separate disciplinary proceedings in which DT Colombia was a respondent, each of which related to DT Colombia's provision of professional services to Colombian companies. Notably, none of the Colombian companies were "issuers" under the Securities and Exchange Act of 1934 or PCAOB rules. DT Colombia learned of the initiation of each of these proceedings between June 2015 and December 2016. DT Colombia filed its Form 3 apprising the PCAOB of these proceedings on 30 June 2017. In the interim, five of the seven disciplinary proceedings had concluded – a fact also reported on the June 2017 Form 3.

The PCAOB found DT Colombia violated Rule 2203 by failing to timely report the above-specified events because the firm waited between seven months and two years to report the initiation of each of the seven proceedings, and four to thirteen months after learning five of the proceedings had concluded. The Board further found DT Colombia's internal compliance and reporting systems had failed to identify the initiation or conclusion of these proceedings as reportable under Rule 2203.

The PCAOB affirmed the import of timely reporting, citing its own comments in adopting Rule 2203 that "reportable events will sometimes occur, and the public interest, as well as the ability to consider whether prompt action is warranted by the Board's inspection or enforcement staff, will be served by contemporaneous reporting of the event."

As the order illustrates, these timely reporting obligations apply equally (i) to disciplinary proceedings based on professional services provided to companies not considered issuers under US securities laws and PCAOB rules, and (ii) to non-US firms registered with the PCAOB, even where those disciplinary proceedings originate – and wholly remain – in jurisdictions outside the US.

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