REPRINT FINANCIER WORLDWIDE

JANUARY 2017

FINANCIER WORLDWIDE corporatefinanceintelligence

ACCOUNTING & FINANCE

Accountants' liability

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Accountants and auditors play a crucial watchdog function for the financial sector. They facilitate transparency, certify that financial statements accurately represent the financial condition of companies and help keep businesses and their executives honest. But with this great responsibility comes increased risk. Audited financial statements routinely inform business decisions and any deviation from established accounting standards can have devastating repercussions. As a result, when a business fails, falls on hard times, goes into bankruptcy or experiences some other catastrophic financial event, it is becoming more and more common for those who lost money – banks, creditors and investors – to look to the auditors to be made whole.

PwC knows this reality all too well. Following the 2008 housing crash, one of the largest mortgage companies in the US, Taylor Bean & Whitaker (TBW), declared bankruptcy. TBW's bankruptcy trustee subsequently discovered a multi-billion dollar fraud between TBW's founder and executives at Colonial Bank, a lender that supplied TBW with loans. The bankruptcy trustee brought a lawsuit in Florida state court against PwC, which audited Colonial Bank's parent company.

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In Taylor Bean & Whitaker Plan Trust v. PricewaterhouseCoopers LLP, the trustee alleged that PwC failed to identify the fraud, and "certified the existence of more than a billion dollars of Colonial assets that did not exist, had been sold to others, or were worthless". While certainly not the first accountant's liability case, the $5.5bn demand makes it one of the largest.

After years of litigation, contentious discovery and numerous dispositive and pre-trial motions, the parties proceeded to trial in August 2016. After 11 days of testimony, a settlement was reached. While a jury did not ultimately find PwC liable, the fact that the case made it to trial at all strongly supports the continued viability of claims based on accountant's liability. The court's rulings on dispositive motions in the PwC litigation offer numerous lessons that may be useful to other parties contemplating similar claims.

Privity

The complaint stated a single cause of action against PwC for negligent misrepresentation, pursuant to the Restatement Second Torts, Section 552. Section 552 provides that a party who provides false information for the guidance of others in their business transactions is subject to liability for harm caused by justifiable reliance upon the information if reasonable care or competence was not exercised in obtaining or communicating the information. Additionally, Section 552 imposes liability on those under a public duty to provide information when the information was intended to benefit a particular class of individuals.

A central issue in the PwC litigation was the fact that PwC did not audit TBW or Colonial Bank. Rather, PwC audited Colonial Bank's parent company. PwC initially argued that the complaint should be dismissed because the pleadings failed to allege sufficient facts regarding reliance, specific audit reports and transactions entered into, and how any reliance was justified. The court disagreed, and allowed the plaintiff to proceed on its claims.

Following discovery, PwC sought summary judgment on the Section 552 claim, arguing that it owed no duty, public or otherwise, to the plaintiff. Despite the fact that PwC did not provide services to TBW, the court denied PwC's motion finding that a Section 552 claim "could apply when a public company is at the centre of the dispute".

The clear take away is that under appropriate circumstances, courts appear willing to permit broad claims against auditors under an accountant's-liability theory. Here, this resulted in the court allowing claims against an auditor that did not audit the plaintiff's company or even the other company engaged in the alleged fraud. As such, potential litigants should think carefully about the scope of potential claims and culpable parties, particularly when they have relied upon audit reports of public companies when making business or investment decisions that have gone awry and resulted in loss.

Independence

Another central issue in the PwC litigation was PwC's alleged lack of independence. The American Institute of Certified Public Accounts requires members in public practice to be independent in the performance of professional services as required by promulgated standards. This standard works to minimise the threat that certain relationships may impair objectivity or result in less than impartial audits. A lack of independence offers an easy explanation to potential litigants as to why the results of an audit may have been misrepresented.

In the PwC litigation, PwC's independence was questioned in multiple regards. First, the plaintiff argued that indemnification language included in a 2004 engagement letter related to the audit of another Colonial subsidiary entity resulted in a loss of independence. The clause read: "because of the importance of oral and written management representations to an effective audit, the Company releases and indemnifies PricewaterhouseCoopers LLP and its personnel from any and all claims, liabilities, costs and expenses attributable to any knowing misrepresentation by management".

The Securities and Exchange Commission's Financial Reporting Policies explicitly provide that the inclusion of indemnification language in an engagement agreement "would also impair the firm's independence". The court granted summary judgment in favour of the plaintiff on the issue of independence, finding that because prohibited indemnification language was used, and the subsidiary's financials were included in the parent's consolidated financial statements, independence was lost for the year 2004 as a matter of law.

Additionally, the plaintiff argued at trial that PwC violated auditor independence standards for the years 2005 and 2006 because a member of its audit team took a position with Colonial. While this independence issue was not resolved by the court or the jury, it is telling that the announcement of the parties' settlement was made the day after the SEC's former chief accountant testified that he believed this conduct violated independence standards.

Ultimately, independence is a sensitive issue and should be carefully analysed when evaluating potential claims. As this case reveals, the analysis is not as simple as just looking at the relationship between the auditor and its client, but requires a thorough evaluation of the relationships with related companies and employees. Further, given that most firms offering attest services also offer a variety of non-attest services, including advisory services, consulting, bookkeeping and the preparation of financial statements, consideration should also be given to whether other conflicts of interest may exist.

In pari delicto

Yet another setback for PwC came with the court's summary judgment ruling in favour of the plaintiff on PwC's *in pari delicto* affirmative defence. PwC sought to argue that TBW was "in equal fault" because TBW's executives were complicit in the underlying fraud between TBW and Colonial. Specifically, PwC pointed to the fact that TBW executives lied, falsified documents and fabricated transactions to perpetuate the fraud.

But under Florida law, the *in pari delicto* defence requires not just that the parties be equally at fault, but also that the parties "participate in the same wrongdoing". As a result, the court held that because there was "no evidence in the record that plaintiff participated in the same wrong-doing", PwC's defence necessarily failed. While the application of the *in pari delicto* defence may differ, depending on local law, the PwC litigation should offer some solace to potential litigants that are reluctant to assert claims against an auditor because of some other, unrelated wrongdoing that they may have been involved with.

In summary, accountant's liability provides a powerful cause of action and remedy to stakeholders that rely on information in audit reports that turn out to be false or misleading. As PwC learned the hard way, liability may extend well beyond harm incurred by an attest client, at least when the client is a public company. While the case did not end in a jury verdict, the mid-trial settlement reveals that these claims were taken seriously by PwC, and that that its potential exposure and risk of an unfavourable verdict were significant enough to merit settlement. ■