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BDO: Vicarious Liability for Accounting Networks and Member Firms

Clare Canning (London)

Stanley Parzen (Chicago)

Andy Pincus (Washington DC)

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Overview

- Background
- The law prior to *Parmalat* and *BDO International*
- *Parmalat*
- *BDO International*
- Practical Implications
- Attorney-Client Privilege: another looming threat?

Vicarious Liability under US Law

- Used by plaintiffs to add “deep pockets” defendants and/or to provide basis for invoking US courts
- A variety of theories; focus on substance over form
  - Principal/Agent – Actual Authority
  - Joint Venture
  - Alter-Ego
  - Control Person Liability (Securities Act § 20)
  - Apparent Authority
  - Partnership by Estoppel/One Firm
- Also, assertion of direct liability

Traditional View

- Prior to *Parmalat*, vicarious liability arguments were generally not successful
- Courts relied on notes on website or in marketing materials emphasizing that member firms were separate organizations
- Also relied on network structure preserving separate status of member firms

Parmalat (1)

- Complex cases involving audit of Italy-based entity by Deloitte/Italy and Grant Thornton/Italy
- Vicarious liability claims against:
  - DTT
  - Deloitte/US
  - Grant Thornton International
  - Grant Thornton/US

Parmalat (2)

- Control was critical issue
  - Deloitte/Italy as agent of DTT
    - DTT alleged to have intervened in audit personnel decisions of Deloitte/Brazil
    - Deloitte/Italy allegedly sought input from DTT
    - Court refuses to dismiss claim
  - Deloitte/US as agent of Deloitte/Italy
    - No control found; claim dismissed

Parmalat (3)

- Grant/Italy as agent of GTI
  - GTI alleged to have power to control
  - Expulsion of individual partners of Grant/Italy and eventually of Grant/Italy firm alleged to show control
  - Court refuses to dismiss claim
- GTI as agent of Grant/US
  - Ownership of IP
  - Control of decisions regarding admission of member firms and other critical decisions
  - Court refuses to dismiss claim

Parmalat (4)

- Promotional materials not controlling
  - Promotional materials referring to firm as global and use of common name were not sufficient to find agency
  - Fact that the promotional literature stated that the entities were separate was not sufficient to negate the possibility of actual agency

BDO International (1)

- BDO/US sued with respect to audit
  - Multi-million fraud not discovered in audit
- Vicarious liability claim asserted against BDO International
  - Only theory of actual agency permitted to be asserted at trial
- Trial judge entered judgment for BDO International on ground plaintiffs had failed to present sufficient evidence of actual agency
- Appellate court reversed, holding that jury should have been permitted to consider the actual agency claim

BDO International (2)

- Actual agency standard:
  - Principal acknowledges agent will act for him
  - Agent accepts the undertaking
  - Control by principal over agent

BDO International (3)

- Acknowledging agent
  - Network agreement stated that one of BDO International's "objects" was to "manage and control" member firms
  - BDO International official testified that it "coordinated" and "monitored" BDO/US
  - Member Firm Agreement (MFA) reserved ownership of IP (manuals and software) to BDO International
  - BDO International promulgated audit manuals
  - BDO International annual reports: duties included "implementing international quality control and training programmes"
- Acceptance by agent
  - MFA alone could have been sufficient to satisfy this element

BDO International (4)

- Control
  - Court looked to right to control, not actual exercise of control
  - Right to control found in
    - BDO International "manage and control" language
    - MFA (1) regulation of name, logo, software; (2) obligation to provide services at BDO International's request and to comply with audit manuals; and (3) right to review
  - BDO International annual report references to "strict quality controls" and "stringent conditions" required for membership in BDO network
- Although decision by state intermediate appellate court (rather than federal court), this is first decision based on full trial record rather than allegations of complaint

BDO International (5)

- Court recognized that even if there was an agency relationship, liability could be imposed on BDO International only if its agent (BDO/US) was acting within the scope of the agency
  - If conduct in question was contrary to policies of coordinating entity, then it may be outside the scope of the agency
  - As a practical matter, this element may require proof of coordinating entity involvement in the particular engagement
  - Remains an open issue

Key Elements of *BDO International*

- Facts
  - BDO International documents stated one object was to “manage” and “control” member firms
  - BDO International could require personnel from member firms
  - BDO International control of IP, audit manuals and procedures, and right to review
- Legal standard
  - Court’s focus on possibility of control rather than actual exercise of control in connection with challenged audit
- Precedential effect
  - State courts less respected than federal courts BUT this decision is based on evidentiary record
- Additional incentive for plaintiffs’ lawyers to assert vicarious liability claims?

Practical Implications (1)

- Commercial realities facing networks
  - Push by regulators (e.g. SEC) for more coordination, similar quality in all parts of the world
  - US PCAOB regulation of/inspection of ex-US member firms
  - Global application of independence requirements
  - Push by clients for seamless global services
  - Consolidation of country member firms in some parts of the world (e.g., Europe)
  - Opportunity to control risk centrally

Practical Implications (2)

- Threat of vicarious liability must be viewed/addressed in the context of the business realities
- It may make sense to run a legal risk – but important that the nature of the risk is understood and controlled where possible
- Suggested goal: Reasonable steps to reduce vicarious liability risk without adversely affecting business imperatives

Practical Implications (3)

- Step 1: Review structure
  - e.g. Ownership of IP, audit methodology etc
- Step 2: Review documents relating to structure and other written materials
  - Engagement letters: at MF level
  - Scrub organizational documents and MFA to ensure that they expressly disavow “control” by coordinating entity over member firms and expressly affirm the independence of the member firms
  - Disclaimers in literature/websites, etc: not necessarily conclusive but absence may be held against firms
  - Include language in engagement letter specifying that only party responsible for engagement is the originating member firm

Practical Implications (4)

- Step 3: Identify actions that might be misused by plaintiffs to increase coordinating entity liability risk, and undertake cost/benefit assessment
  - Involvement of coordinating entity (including coordinating entity personnel) in specific audit decisions and/or specific audit staffing decisions
  - Sharing of profits
  - Individual with key roles in both coordinating entity and member firm
  - Authority to remove member firm or partners of member firm

Practical Implications (5)

- Step 4: Identify actions that might be misused by plaintiffs to increase risk of liability spillover to other member firms, and undertake cost/benefit assessment
  - Significant control by one or more member firms over actions of the coordinating entity
  - Individuals with key roles in both coordinating entity and member firm
  - Sharing of profits
  - Compliance with legal formalities in connection with secondments
  - Appearance of control by one member firm over the work of another member firm
- Step 5: Police behaviour on the ground so far as possible

Threat to Attorney-Client Privilege (1)

Issue: Whether communications regarding member firm litigation are protected against disclosure in US litigation by the attorney-client and/or attorney work product privileges

- Communications between coordinating entity lawyers and the coordinating entity board
- Communications between coordinating entity lawyers and member firm.

Threat to Attorney-Client Privilege (2)

- *Allied Irish Banks* decision by federal district court in New York
- Refused to recognize privilege for intra-coordinating entity documents on ground that the attorneys and the recipients had both global and member firm roles and submission did not make clear they were acting in global roles
  - Could be clarified with clearer documentation
- Refused to recognize privilege for communications with member firm on ground that "common interest" branch of the attorney-client privilege applies only to advice "in pending or reasonably anticipated litigation." Because litigation against the coordinating entity was not anticipated, the privilege was not available.

Threat to Attorney-Client Privilege (3)

- Court upheld member firm's assertion of work product privilege with respect to some of the documents, subject to a showing of need sufficient to overcome the privilege.

- Decision shows that closer attention to privilege issues is important to preserving confidentiality, especially when separateness of various entities is emphasized in other contexts.

Mayer Brown Accountants Team

- This is the first of a series of webinars and other events exploring issues of interest to accounting networks.

- Our Accountants Team is made up of experienced lawyers from the Americas, Asia and Europe. With our deep experience through our long-standing relationships with accounting networks and our offices worldwide, we have the resources necessary to respond quickly to any issue, contentious or otherwise, faced by leading accounting firms.

Thank You

- Questions & Answers