In a Clear Victory for Institutional Investors, Court Finds U.S. Accounting Firm and its International Organization can be Held Liable for Audits Conducted by Foreign Affiliates

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In a January 27, 2009 decision in *In re Parmalat Securities Litigation*,[2] Judge Lewis Kaplan of the U.S. District Court for the Southern District of New York addressed the issue of whether a U.S. accounting firm and the international organization of which it is a member can be held liable for securities violations committed by a member firm practicing in another country. In a lengthy and detailed opinion, the Court denied the defendants' motion for summary judgment and held that the plaintiffs had submitted sufficient evidence that the foreign firm was controlled by, and acted as an agent for, the U.S. and international firms, so that the issue had to be resolved by a jury at trial.

The Facts of the *Parmalat* Case

In the early 1990s, Parmalat, an Italian dairy conglomerate was burdened by massive debt and losses from operations. To hide its deteriorating financial condition, insiders at Parmalat concocted a scheme involving misleading transactions and off-shore entities that created the appearance of financial health.

Parmalat hired Deloitte & Touche S.p.A. ("DT-Italy") as its auditor. DT-Italy was a member firm in Deloitte Touche Tohmatsu ("DTT"), the worldwide Deloitte organization. DT-Italy allegedly discovered or recklessly ignored the fraud, yet certified the company's financial statements as fairly presenting its financial condition.

By late 2003, the scheme became unsustainable. Parmalat had a liquidity crisis, and the ensuing collapse was rapid. In early December, Parmalat could not pay certain maturing bonds. By December 11, the company's stock had lost half of its value. Parmalat's bonds rapidly lost value as well. On December 19, the company announced that a Bank of America account allegedly held by its affiliate that supposedly contained $4.9 billion did not exist.

Parmalat filed for bankruptcy in Italy on December 24 and was declared insolvent three days later. Italian authorities thereafter indicted a number of Parmalat executives and insiders as well as auditors from DT-Italy.

In re Parmalat Securities Litigation is a federal securities class action alleging violations of the Securities Exchange Act of 1934, and it involves what the SEC has aptly described as "one of the largest and most brazen corporate financial frauds in history."

In the complaint, the plaintiffs alleged two bases for holding DTT and DT-US liable for the audits conducted by DT-Italy: (1) that DT-Italy acted as an agent for DTT and DT-US, and (2) that DT-US and DTT controlled DT-Italy and were therefore liable under the control person provision of the Exchange Act.[3] In the January 27, 2009 opinion, the Court addressed and rejected the defendants' motion for summary judgment with respect to both of these bases of liability.

Vicarious Liability after *Stoneridge*

The first question the Court addressed was whether the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[4] precluded holding DTT and DT-US vicariously liable on the theory that DT-Italy acted as their agent.

The Deloitte defendants argued that the *Stoneridge* decision barred common law claims of *respondeat superior* for Exchange Act claims, and therefore neither entity could be held liable on an agency theory for the acts of DT-Italy.

Judge Kaplan found that the *Stoneridge* decision "did not address the question of whether a principal is liable vicariously for an Exchange Act violation committed by its agent acting within the agent's scope of employment." The Court also stated that *Stoneridge* did not alter the common law principle of *respondeat superior*, and as such, the Court refused to do so in this case.

DTT's and DT-US's Control Over DT-Italy

Turning to the merits of the claims, the Court noted that both the control person claims and the agency claims hinged on whether DTT and DT-US had the power to exercise control over the conduct of DT-Italy.

Control may be demonstrated by "showing that the defendant 'possessed the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'"[5] "[O]nly the ability to direct the actions of the controlled person, and not the active exercise thereof" is required to establish control.[6]

Judge Kaplan carefully examined the factual record, including the depositions of numerous representatives of DTT, DT-US and DT-Italy and numerous documents produced by them, and held that the plaintiffs had presented "numerous facts that could be taken as indicating that DTT structured and conducted itself in a manner that permitted it to exercise control over its member firms, including Deloitte Italy." He noted that DTT set the policies that governed member firms' audit procedures, that DTT had control over the acceptance and rejection of engagements by member firms, that DTT required use of the Deloitte name, that DTT played a substantial role in the legal and risk management affairs of member firms, and that the DTT Practice Manual confers authority on DTT's chief executive officer to resolve member firm disputes. Given the totality of the evidence, the Court concluded that there was sufficient evidence from which a jury could conclude that "DTT had the power to impose its will on a member firm's professional judgment and that it exercised that power…"

Judge Kaplan further found that there was sufficient evidence from which a jury could conclude that DT-US controlled DTT (and therefore was also vicariously liable for DT-Italy's conduct). He based this conclusion on the facts that DTT was heavily dependent on DT-US for financial support and that the CEO and many other key officers of DTT were invariably partners of DT-US.

Lessons to Be Learned

For years, the big accounting firms have sold themselves as global entities that can provide seamless service around the world. As soon as something went wrong with an audit conducted by a foreign member firm, however, the worldwide organization would claim that it had no responsibility. The *Parmalat* decision is a significant victory for investors in that it holds that these global accounting organizations can indeed be held vicariously liable for the actions of their foreign member firms. While it remains to be seen how the decision will be applied in the future, the ruling should force accounting firms either to reorganize in a way that can provide greater protection from liability or begin to do a better job of policing member organizations.

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2. Nos. 04 MD 1653 (LAK), 04 Civ. 0030 (LAK), 2009 WL 179920 (S.D.N.Y. Jan. 27, 2009).
3. 15 U.S.C. § 78(t)(a).
4. 128 S. Ct. 761 (2008)
5. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-73 (2d Cir. 1996) (quoting 17 C.F.R. § 240.12b-2).
6. *See Dietrich v. Bauer*, 126 F.Supp.2d 759, 764-65 (S.D.N.Y .2001); *see also In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 352 F.Supp.2d 429, 458 (S.D.N.Y.2005).

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