# SDNY Rejects International Audit Firm's Argument That *Stoneridge* Precludes Vicarious Liability Under Securities Law for Acts of its Member Firm

In *In re Parmalat Securities Litigation*,[1] the District Court for the Southern District of New York (Kaplan, J.) denied a motion for summary judgment by Deloitte & Touche defendants,[2] who claimed they could not be held liable for acts of a distinct member firm under the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[3] The Deloitte defendants argued that the Court's holding in *Stoneridge*, that § 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder could not be used to bring an action against third-party aiders and abettors, should be read to obviate a *respondeat superior* claim against other Deloitte entities for acts allegedly committed by a member firm. The district court held that *Stoneridge* was inapposite because the *Stoneridge* Court did not consider a case where defendants were alleged to have a principal-agent relationship with a primary violator of the Exchange Act. Furthermore, the district court held that despite Deloitte's organizational structure and its assertion that its member firms were independent, the plaintiffs had presented enough evidence to raise a question of fact regarding Deloitte's control over its member firms for the purpose of § 10(b) and Rule 10b-5, as well as a claim under § 20(a) of the Exchange Act.

## I. The Alleged Facts

During the 1990s, Italian dairy manufacturer Parmalat, facilitated by its auditor at the time, Grant Thornton, engaged in a scheme to cover up large losses by creating fake transactions with shell companies, selling the accounts receivable to a bank and loaning the shell company money to pay the bank.[4] Parmalat accounted for the transactions in a manner that gave the appearance of increasing its revenues and decreasing its debt. Thus, Parmalat was able to trick financial institutions into lending it more money by appearing financially sound.

In 1999, Parmalat was required by Italian law to change auditors, which led to its engagement of Deloitte & Touche S.p.A. ("Deloitte Italy").[5] Prior to the Deloitte engagement, Parmalat attempted to cover up its ongoing accounting fraud by moving those transactions to Bonlat, its Caribbean subsidiary that Grant Thornton would continue to audit. Deloitte Italy examined and reported upon Parmalat's financial statements until Parmalat suffered a liquidity crisis at the end of 2003 and went insolvent. Several Parmalat executives and Deloitte Italy were indicted by the Italian government. A class of plaintiff shareholders of Parmalat securities sued, *inter alia*, Deloitte Italy, Deloitte Touche Tohmatsu ("DTT"), Deloitte & Touche LLP ("DT-US") and Deloitte executive James Copeland for violations of §§ 10(b) and 20(a) of the Exchange Act, as well as Rule 10b-5.[6]

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1 *In re Parmalat Securities Litigation*, Nos. 04-MD-1653, 04 Civ. 0030, 2009 WL 179920, at *1 (S.D.N.Y. Jan. 27, 2009) (hereinafter "*Parmalat*").

2 The scope and complexity of Deloitte's international organization and its various entities is discussed *infra*.

3 128 S. Ct. 761 (2008) ("*Stoneridge*").

4 *Parmalat*, 2009 WL 179920, at *2 n. 19.

5 *Id.* at *3.

6 *Id.* at *1.

The Deloitte entities were organized such that DTT was a Swiss "verein"[7] and Deloitte Italy, DT-US and other member firms were organized as limited liability entities under the laws of their respective jurisdictions. Member firms such as Deloitte Italy followed accounting and audit standards promulgated by DTT, in addition to the rules in their respective jurisdictions.[8] Deloitte structured its business with the purpose of "project[ing] the image of a cohesive international organization" that provided "consistent seamless service across national boundaries."[9] Each Deloitte member firm agreed to DTT's governing document,[10] which essentially required the member firms to adhere to DTT's policies, procedures and protocols, specifically with regard to the manner in which professional services were rendered to clients. DTT controlled member firms' engagement of clients and managed to some extent the manner in which engagements were staffed by transferring employees from one firm to another and combining the services of different member firms under the direction of a single partner.

## II. Deloitte's Motion for Summary Judgment

DTT, DT-US and Copeland moved for summary judgment dismissing the Exchange Act claims against them on the grounds that they did not exercise control over Deloitte Italy sufficient to be found liable under a theory of *respondeat superior* for Deloitte Italy's violations of the Exchange Act, or that alternatively they were not jointly and severally liable pursuant to Section 21D(f)(2)(A) of the Private Securities Litigation Reform Act ("PSLRA"). Deloitte argued that the Court's *Stoneridge* decision foreclosed "common-law" claims of secondary liability, such as those against DTT or DT-US for the actions of their alleged agent, Deloitte Italy. Deloitte asserted that the only basis for vicarious liability under the Exchange Act after *Stoneridge* was § 20(a), which provides for joint and several liability for defendants that controlled a primary violator.

The Deloitte defendants also argued that even if they could be found liable under a theory of *respondeat superior*, plaintiffs failed to raise an issue of material fact regarding whether DTT or DT-US and Deloitte Italy had a principal-agent relationship because (i) they lacked control over Deloitte Italy, (ii) even if they controlled Deloitte Italy they acted in good faith, and (iii) in any event they could not be found jointly and severally liable with Deloitte Italy under Section 21D(f)(2)(A) of the PSLRA, which limits such liability to defendants who knowingly commit violations of the Exchange Act.[11]

## III. The District Court's Opinion

Judge Kaplan first addressed the Deloitte defendants' *Stoneridge* argument, noting that the Court's opinion stated explicitly "that § 10(b) 'does not incorporate common-law fraud into federal law.'"[12] However, the court held that the Deloitte defendants presented a different legal question than the *Stoneridge* defendants; DTT, DT-US were alleged to be liable for the acts of Deloitte Italy as their "agent." Judge Kaplan noted that the majority rule was to "permit[] the application of the common-law principle of *respondeat superior* to hold

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7 A Swiss verein is a business form that is legally distinct from its member firms and translates to English as "association, society, club or union." *Id.* at *1 n. 5.

8 *Parmalat*, 2009 WL 179920, at *2.

9 *Id.*

10 The "Articles of the Verein." *Id.* at *6.

11 *Parmalat*, 2009 WL 179920, at *4.

12 *Id.* at *4.

principals liable for Section 10(b) violations by their agents"[13] and if the Court had meant to overturn such a basic doctrine of American law it would have done so explicitly, and that it did not.

Next, Judge Kaplan discussed whether the plaintiffs had enough evidence to go forward with a theory that DTT had a principal-agent relationship with Deloitte Italy.[14] The court observed that the plaintiffs had pointed to many facts from which one could conclude that DTT was structured in such a manner that it could exercise control over its member firms, and that it had authority to resolve disputes between member firms. Among the facts the court found indicative of DTT's control over the member firms: DTT's dictation of policies and procedures to member firms, its power to review member firms' audits for compliance with its policies, its control over member firms' engagements and its provision of legal and risk management services to member firms. Moreover, the court noted that DTT had resolved a dispute between Deloitte Italy and Deloitte Brazil over whether Parmalat Brazil should have disclosed a particular transaction.[15] Thus, the court held that evidence regarding DTT's structure taken together with evidence that it influenced the outcome of a particular audit report could reasonably lead to the conclusion that DTT controlled its member firms.[16]

Judge Kaplan next turned to DTT's assertion that the plaintiffs' § 20(a) claim should be dismissed, holding that under § 20(a) the plaintiffs were required only to demonstrate DTT's control over Deloitte Italy generally, and not with regard to the specific transaction at issue, and finding that plaintiffs had put forth enough evidence for a jury to find that DTT controlled Deloitte Italy, either generally or regarding the transaction at issue.

The court also addressed DTT's argument that it acted in good faith, holding that DTT's assertion that there was no evidence that it "[knew] of or recklessly disregarded any fraud by Deloitte Italy in connection with the Parmalat audits" did not necessarily demonstrate good faith.[17] Similarly, the fact that DTT had a compliance review system, in the absence of evidence regarding how it implemented this system during the Parmalat engagement, did not necessitate a finding that DTT acted in good faith.[18] Finally, the court held that DTT's resolution of the Deloitte Italy-Deloitte Brazil dispute in favor of disclosure, and its subsequent inquiry into a similar transaction by Parmalat Argentina to determine if other Parmalat subsidiaries were not disclosing such transactions was not enough to find as a matter of law that DTT acted in good faith.[19]

Judge Kaplan held that DT-US was not entitled to summary judgment because there was sufficient evidence for a jury to conclude that it controlled DTT, and thus Deloitte Italy, for the purpose of a § 20(a) claim.[20] Plaintiffs pointed out that many DT-US partners occupied "key DTT positions," that DTT was reliant on DT-US for funding and that DT-US partners controlled DTT's decision regarding whether it would separate its consulting

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13 *Id.* at *5.

14 *Id.* at *6.

15 *Id.* at *8.

16 *Id.* at *9.

17 *Id.* at *11.

18 *Id.* For a recent opinion in a criminal case addressing a similar "compliance policy" argument, see *United States v. Ionia Management S.A.*, Nos. 07-5801-cr, 08-1387-cr, 2009 WL 116966, at *1 (2d Cir. Jan. 20, 2009) (holding that the government was not required "to prove as a separate element in its case-in-chief that the corporation lacked effective policies and procedures to deter criminal actions by its employees.").

19 *Id.* at *12.

20 *Id.*

business from its audit business for independence purposes. Additionally, the court held that DT-US was not entitled to summary judgment on the good faith defense for the same reasons it stated with regard to DTT.[21]

Finally, Judge Kaplan held that because Copeland was CEO of both DTT and DT-US he was not entitled to summary judgment on the ground that he was not a control person under § 20(a), and that he was not entitled to the good faith defense as a matter of law for the same reasons the other defendants were not.[22]

Regarding the PSLRA defense, the court held that Section 21D(f)(2)(A) was not enacted with the intent to "alter traditional principles of vicarious liability," and that the Deloitte defendants were thus not entitled to summary judgment on the issue of joint and several liability for Deloitte Italy's alleged fraud.[23]

## IV. Comments

Judge Kaplan's decision in *Parmalat* is one of two recent decisions addressing *respondeat superior* liability for violations of the Exchange Act.

The other, an earlier decision of the Seventh Circuit, *Pugh v. Tribune Co.*,[24] arose from the fraudulent acts of employees of a subsidiary, which plaintiffs sought to use as the basis for holding the parent company liable for violations of the Exchange Act. Because the subsidiary's employee had not prepared the parent's financial statements or made any other public disclosures upon which the plaintiffs had relied, the Seventh Circuit held that *Stoneridge* precluded liability based on their actions. The court held that even if the subsidiary's employee were found to be a primary violator, there was no *respondeat superior* liability for the parent because he was neither a "senior-level" officer of the parent, nor was he acting to benefit the parent.

*Parmalat* and *Pugh* present two distinct, but somewhat similar, factual situations. On the one hand, the actions of a "member firm" found to have violated the Exchange Act can lead to its principal's liability through *respondeat superior*. On the other, the actions of a subsidiary's non-senior-level employee who did not commit a primary violation of the Exchange Act could not be used to establish vicarious liability for the parent where the employee did not act as an agent of the parent nor for its benefit.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

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21 *Id.* at *13.

22 *Id.* at *13-14.

23 *Id.* at *14.

24 521 F.3d 686 (7th Cir. 2008). *Pugh* is not cited in *Parmalat*.

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