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Accountant's Fiduciary Duty as Independent Auditor in North Carolina

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In North Carolina, an accounting firm now owes a fiduciary duty to its audit client, both as a matter of law and as a matter of fact.

On November 4, 2014, a North Carolina appellate court held — for the first time — that an accounting firm has a fiduciary duty to its client when performing an independent audit. See Commscope Credit Union v. Butler & Burke, NO. COA14-273, 2014 N.C. App. LEXIS 1131 (N.C. App. Nov. 4, 2014).

The decision in Commscope concerned a credit union that hired accounting firm Butler & Burke, LLP, to perform an independent audit of the business. The engagement letter included the following terms about the scope of the accounting firm's services:

> Plan and perform []audit[s] to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether from errors, fraudulent financial reporting, misappropriation of assets, or violations of laws or government regulations that are attributable to [the credit union] or to acts by management or employees acting on behalf of [the credit union].

Unbeknownst to the credit union, its general manager had failed to file the IRS Form 990 for the years 2001 to 2009. During the course of the audit, the accounting firm did not request these tax forms and, as a result, never discovered the credit union's filing deficiency. In April 2010, the IRS penalized the credit union approximately $400,000 for its failure to file.

The credit union sued the accounting firm for breach of contract, negligence, breach of fiduciary duty, and professional malpractice. The accounting firm moved to dismiss the claims, and the trial court granted the motion to dismiss — kicking all of the credit union's claims. On appeal, however, the Court of Appeals reversed the trial court's decision.

To begin its analysis, the Court noted that a fiduciary duty may arise either (1) as a matter of law or (2) as a matter of fact. A fiduciary duty arises as a matter of law in certain relationships —such as

attorney and client, broker and principal, guardian and ward — because of "the nature of the relationship;" in such relationships, one party "figuratively holds all the cards — all the financial power or technical information[.]" Alternatively, a fiduciary duty arises as a matter of fact when there has been a "special confidence reposed" in one who is "bound to act in good faith and with due regard" to another.

Turning to the context of accounting firms, the Court addressed whether a fiduciary duty to a client could exist as a matter of law. The Court first recognized that in a previous decision, Harrold v. Dowd, 149 N.C. App. 777, 561 S.E.2d 914 (2002), the Court had held that an accounting firm did not owe a fiduciary duty to a client when the firm was hired "to advise them on business opportunities, including mergers and acquisitions." The Court noted that the Harrold opinion contrasted advising on mergers and acquisitions with the situation where an accounting firm "had done an accounting and had prepared tax filings[.]" Thus, in summarizing Harrold, the Court concluded that — despite Harrold announcing that North Carolina had never recognized a per sefiduciary relationship between an accounting firm and a client — Harrold left open the possibility that a fiduciary relationship could arise when an accounting firm performed an independent audit.

The Court then discussed Smith v. Underwood, 127 N.C. App. 1, 487 S.E.2d 807 (1997), stating (actually misstating) that in Underwood the Court had previously found a fiduciary relationship between an accountant and its clients in that particular factual context where "the accountants were providing accounting and tax-related services." This finding was directly contrary to the decision in Harrold where the Court stated "nowhere in Underwood opinion does this Court state that there existed a fiduciary relationship between accountant and client." 149 N.C. App. at 784, 561 S.E.2d at 919.

Relying on Harrold and Underwood, the Court announced that an accounting firm, when "using its specially trained professionals to perform comprehensive audits," appears "to hold all the technical information." Therefore, the auditor-client relationship is "much more like that between attorney and client [or] broker and principal" than between mutually independent businesses. Consequently, the Court held that a fiduciary duty existed as a matter of law between an accountant and its audit client.

The Court then analyzed the question of whether a fiduciary duty existed under the particular facts of the case. Based on the standard engagement letter language which states that audit procedures are designed to identify fraud by employees, the Court concluded that the accounting firm "sought and received" the audit client's special confidence and held that the accounting firm owed a fiduciary duty to the audit client as a matter of fact.

The Court went on to reject the accounting firm's various defenses against the claims. First, the Court dismissed the defense that the credit union could not sue because it was equally responsible for the harm (in pari delicto); the Court ruled that this defense was only available if the client had intentionally caused the harm, and here the conduct was likely negligent. Second, the Court discarded the defense of contributory negligence because the general manager's conduct could not be attributed to the credit union. Third, the Court rebuffed the argument that the credit union's responsibilities under engagement letter (e.g., maintain internal controls and provide all financial records) shielded the accounting firm from liability because the engagement letter imposed overlapping responsibilities on the accounting firm.

The overall holding is that in North Carolina, an accounting firm now owes a fiduciary duty to its audit client, both as a matter of law and as a matter of fact.

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