

## NC Supreme Court Holds Independent Auditors Do Not Owe Fiduciary Duty to Clients

By Sean Hennessy, James Thomas, and Arthur Luk – November 29, 2016

In *CommScope Credit Union v. Butler & Burke, LLP*, 790 S.E.2d 657 (N.C. 2016), the North Carolina Supreme Court held that independent auditors do not categorically owe a fiduciary duty to their clients. Rather, *CommScope* explains that the determination of whether a fiduciary duty exists is based on the specific facts of any given case and in so doing provides guidance for practitioners representing independent auditors.

In *CommScope*, a credit union hired a certified public accounting firm to conduct annual audits of the credit union's financial statements. Thereafter, the credit union filed a lawsuit in state court alleging that, in conducting annual audits, the accounting firm failed to review the credit union's tax returns and therefore failed to discover that its general manager had not complied with federal tax filing requirements for nine years, resulting in nearly \$375,000 in IRS fines. The credit union asserted claims for breach of contract, negligence, breach of fiduciary duty, and professional malpractice.

The trial court granted the accounting firm's motions to dismiss and for judgment on the pleadings as to all claims. The court of appeals reversed, finding that an independent auditor and an audit client may have a fiduciary relationship as a matter of law and determining that the allegations in the complaint were sufficient to state a claim for breach of fiduciary duty. The court of appeals deemed language in the audit-engagement letter assuring the credit union that the accounting firm had the expertise to review financial statements to identify errors and fraud by the credit union's employees, sufficient to establish a fiduciary relationship. The North Carolina Supreme Court granted discretionary review to determine, inter alia, whether the accounting firm owed a fiduciary duty to the credit union.

The court first held that there is not a categorical fiduciary relationship between an independent auditor and an audit client because "auditors often have significant obligations to third parties [e.g., creditors or investors] or to the public at large that would prevent them from acting solely in their audit clients' best interests." *CommScope*, 790 S.E. 2d at 660. For this reason, the court previously had held that an independent auditor owes a duty to avoid negligent misrepresentations to third parties. The court explained that an auditor's duty to third parties is even "more pronounced" when the client is subject to the requirements of the Securities Exchange Act of 1934 because federal law prohibits auditors from providing

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additional services that could compromise the auditor's independence, auditors may not serve as experts for clients, and the U.S. Supreme Court has held that independent auditors have a duty to the investing public. *See United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

The court next recognized that even though there is not a fiduciary relationship as a matter of law in all cases, "one may arise in fact" whenever "there is confidence reposed on one side, and resulting domination and influence on the other." *CommScope*, 790 S.E. 2d at 660. The court held, however, that the circumstances of the *CommScope* case did not warrant such a finding. Under the engagement letter, the accounting firm agreed to conduct the audits in conformance with generally accepted accounting standards (GAAS), which required an auditor to: maintain independence from the audit client; be free from obligations to or bias about the client; and consider and further the interests of third parties who may rely on the audit. Because the terms of the engagement letter required the accounting firm to serve interests beyond those of the credit union, there was no fiduciary relationship as a factual matter. The court also noted that the accounting firm did not agree to perform any additional services (e.g., tax-related services) beyond the annual audits that could give rise to a fiduciary relationship. The court accordingly reversed the court-of-appeals decision as to the breach-of-fiduciary-duty claim.

*CommScope* is the most recent example of a court finding that an accounting firm's independent auditing function does not give rise to a fiduciary duty, *see, e.g., Golden West Refining v. Pricewaterhouse*, 2005 WL 2573587 (D. Conn. Oct. 11, 2005); *Micro Enhancement, Inc. v. Coopers & Lybrand*, 40 P.3d 1206 (Wash. App. 2002), and the court's analysis of whether a fiduciary relationship existed as a factual matter serves as helpful guidance. As *CommScope* illustrates, auditors should carefully craft the terms of the engagement letters, evaluate the potential risks of providing services beyond the audit function, and consider whether the governing audit standards (e.g., GAAS) sufficiently establish independence.

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