No. 5PA15 TWENTY-FIFTH JUDICIAL DISTRICT

SUPREME COURT OF NORTH CAROLINA

COMMSCOPE CREDIT UNION,
Plaintiff-Appellant,

v.

BUTLER & BURKE, LLP,
Defendant and Third-Party Plaintiff-Appellee

v.

BARRY D. GRAHAM, JAMES L. WRIGHT, ED DUTTON, FRANK GENTRY, GERAL HOLLAR, JOE CRESIMORE, MARK HONEYCUTT, ROSE SIPE, TODD POPE, JASON CUSHING, and SCOTT SAUNDERS,
Third-Party Defendants

From Catawba County
12-CVS-3021

BRIEF OF *AMICI CURIAE* CHERRY BEKAERT LLP, CLIFTONLARSONALLEN LLP, AND DIXON HUGHES GOODMAN LLP IN SUPPORT OF DEFENDANT-PETITIONER BUTLER & BURKE, LLP

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Pursuant to Rule 28(i) of the North Carolina Rules of Appellate Procedure and the Court's order of 5 March 2015, Cherry Bekaert LLP, CliftonLarsonAllen LLP, and Dixon Hughes Goodman LLP submit this brief as *amici curiae* in support of Defendant-Appellant Butler & Burke, LLP.

ISSUES PRESENTED

1. Whether the Court of Appeals erred in finding the existence of a fiduciary relationship between an independent auditor and its client?
2. Whether the Court of Appeals erred in holding that the failure of a corporate manager to file tax returns for nine consecutive years cannot be imputed to the corporation as a matter of law, even where the officers of the company designated the manager as responsible for filing tax returns?

INTEREST OF *AMICI*

Amici are certified public accounting firms with offices in North Carolina who routinely provide audit services to public and private corporations and businesses in North Carolina. Together, *amici* performed well over 1200 audits of North Carolina organizations in 2014. The Court of Appeals' erroneous decision to find a fiduciary relationship in the context of an independent audit not only directly affects *amici*, but it also has significant public policy implications for North Carolina companies and the public at large.

SUMMARY OF ARGUMENT

The decision below sets a dangerous precedent because it essentially makes an auditor—who is required to provide an independent and unbiased opinion regarding the reasonableness of the financial information prepared and presented

by the company—a trustee or guarantor of the company's financial condition. In reaching this erroneous result, the Court of Appeals committed two significant errors:

First, the Court of Appeals ignored the fact that financial audits, by their very nature, require the auditor to maintain independence from the audit client. Without that independence, auditors cannot exercise the professional judgment and autonomy necessary to do their work, and the public cannot rely on the accuracy and reliability of audited financial statements. Because of this basic principle, North Carolina law, Federal law, and professional accounting standards all mandate that an auditor maintain independence. By imposing a fiduciary duty on the auditor, the Court of Appeals' decision abandons these long-standing and mandatory rules.

Second, the Court of Appeals wrongly held that a general manager's failure to file tax returns is not imputable to the company as a matter of law. That holding is contrary to basic principles of tax and agency law, and further undermines the ability of independent CPAs to do their jobs. The Internal Revenue Service and Federal courts have long held that a company cannot avoid liability for failing to file tax returns by shifting the blame to an employee, and North Carolina law is not to the contrary. Auditors, in turn, must rely on the representations of management regarding their compliance with applicable laws and regulations. By allowing

CommScope to shirk responsibility for its failure to file tax returns and shift the blame to Butler & Burke, the Court of Appeals upset the balance in the auditor-client relationship.

ARGUMENT

I. THE COURT OF APPEALS ERRED IN IMPOSING FIDUCIARY DUTIES ON THE STANDARD AUDIT RELATIONSHIP.

A. The Decision Below Ignores the Requirement of Independence in the Auditor-Client Relationship and Is Contrary to State and Federal Law.

The Court of Appeals' decision disregards the fundamental principle that an auditor must exercise professional independence from its client. As the United States Supreme Court observed 30 years ago, "[p]ublic faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional." *United States v. Arthur Young & Co.*, 465 U.S. 805, 819 (1984). Accordingly, the American Institute of Certified Public Accountants ("AICPA") has promulgated detailed Ethical and Auditing Standards for CPAs. In turn, the North Carolina Board of Certified Public Accountant Examiners (the "Board")—which the State vests with authority to license and regulate CPAs—has made the AICPA Ethical and Auditing Standards mandatory. *See* 21 NCAC 8N. 0403(a)-(b).

The Board also has its own requirement that an auditor "must be independent with respect to the client in fact and appearance." 21 NCAC 8N. 0402.

That rule goes on to identify several categories of traditional fiduciary relationships—such as being an officer, director, or trustee of the client—that preclude an accountant from being independent. *Id*. at 8N. 0402(b). If the Court of Appeals is correct that a traditional audit relationship can also give rise to fiduciary duties, then going forward virtually every CPA who provides audit services in North Carolina will be in direct conflict with the Board's rules.

The Court of Appeals' decision also conflicts with Federal law, which imposes its own independence requirements on accounting firms—like *amici*—who conduct audits of publicly-traded companies. As part of the Sarbanes-Oxley Act of 2002, Congress created the Public Company Accounting Oversight Board ("PCAOB") and expressly directed it to develop "independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports . . . as may be necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C.A. § 7213(a)(1).

PCAOB Rule 3520 unambiguously requires auditor independence: "A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period."[1] Note 1 to Rule 3520 further explains that "a registered public accounting

[1] *Available at* http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx #rule3520.

firm or associated person's independence obligation with respect to an audit client encompasses not only an obligation to satisfy the independence criteria applicable to the engagement set out in the rules and standards of the PCAOB, *but also an obligation to satisfy all other independence criteria applicable to the engagement*, including the independence criteria set out in the rules and regulations of the [Securities and Exchange] Commission under the federal securities laws." (emphasis added; bracketed text inserted).

The Securities and Exchange Commission ("SEC"), in turn, has also adopted detailed, binding regulations concerning auditor independence. *See generally* 17 C.F.R. § 210.2-01. The SEC's regulations state, in part, that the Commission "will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, *capable of exercising objective and impartial judgment* on all issues encompassed within the accountant's engagement." *Id*. § 210.2-01(b) (emphasis added).

Although the decision below dealt with a credit union and not a publicly-traded company, the potential reach of the Court of Appeals' holding extends far beyond credit unions. Specifically, the Court of Appeals held that Butler & Burke's statement in its engagement letters that it would "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 [Plaintiff] or to acts by management or employees acting on behalf of [Plaintiff]" created a fiduciary relationship. (Opinion at p. 9) (brackets in original). The language cited by the Court of Appeals, however, simply reflects the requirement under generally accepting auditing standards that "the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." *See* AICPA Auditing Standard AU 311 at 1635.[2] Those standards do not—and were not—intended to create a fiduciary duty between an auditor and client. Indeed, the auditing standards actually include a sample engagement letter that contains language very similar to that included in Butler & Burke's engagement letters. *See* AICPA Auditing Standard AU-C 210 at 116.[3]

The Court of Appeals' holding thus turns any CPA firm conducting a standard audit of a North Carolina organization into a fiduciary. This result puts CPA firms in an impossible Catch-22. In order to comply with the AICPA standards and North Carolina regulations—plus the PCAOB and SEC requirements

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[2] Available at http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00311.pdf.

[3] *Available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-C-00210.pdf.

when auditing public companies—CPA firms must exercise "objective and impartial judgment on all issues" encompassed within the audit. At the same time, the Court of Appeals' decision requires them to act as fiduciaries "with due regard to the interests" of the company being audited. (Opinion at p. 9, citing *Harrold v. Dowd*, 149 N.C. App. 777, 784, 561 S.E.2d 914, 919 (2002)). These two conflicting mandates are irreconcilable, and, as discussed below, will have a significant adverse impact on both CPA firms and companies in North Carolina.

B. The Decision Below Will Make It Impossible for CPA Firms to Continue to Perform Audits in North Carolina.

The Court of Appeals' conclusion that a CPA firm providing standard audit services owes a fiduciary duty to its client will make it virtually impossible for CPAs to continue to provide audit services to companies based in North Carolina. If the decision below stands, North Carolina will become an extreme outlier in imposing fiduciary duties on independent auditors in the absence of any special circumstances. "The weight of authority is that absent special circumstances, an auditor is not a fiduciary of its client. An independent auditor's primary duty is to the public and this is inconsistent with a fiduciary status." *Micro Enhancement Int'l Inc. v. Coopers & Lybrand, LLP*, 40 P.3d 1206, 1218 (Wash. Ct. App. 2002). Numerous other state and federal courts agree. *See Kolb v. LJ Rabinowitz, CPA*, 117 A.D.3d 978, 980, 986 N.Y.S.2d 523, 525 (N.Y. App. Div. 2'd Dept. 2014) (granting motion to dismiss breach of fiduciary duty claim against CPA who was

hired to perform audit but failed to uncover controller's embezzlement scheme); *Golden W. Ref. v. Pricewaterhouse*, 392 F. Supp. 2d 407, 414 (D. Conn. 2005) ("The mere fact that an accountant has been hired to audit a company has generally been held insufficient to establish a 'relationship of special trust and confidence' giving rise to fiduciary obligations."); *Standard Chartered PLC v. Price Waterhouse*, 945 P.2d 317, 334 (Ariz. Ct. App. 1996) (holding that accounting firm was entitled to judgment notwithstanding verdict on breach of fiduciary duty claim because auditors are not normally fiduciaries of clients).[4]

If the Court of Appeals' decision stands, CPA firms operating in North Carolina will face a stark choice. They can choose to maintain their required independence and risk the possibility of breaching the fiduciary duties ascribed to them by the Court of Appeals, or they can act as their audit clients' fiduciaries and

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[4] *See also Resolution Trust Corp. v. KPMG Peat Marwick*, 844 F. Supp. 431, 436 (N.D. Ill. 1994) ("[M]any courts squarely reaching the question have held that an independent auditor generally is not in a fiduciary relationship with its client. Some courts have gone as far as to observe that the nature of the independent auditor precludes a finding of fiduciary duty.") (citing cases); *FDIC v. Schoenberger*, 781 F. Supp. 1155, 1157-58 (E.D. La. 1992) ("[A]ccountants do not owe a fiduciary duty to their clients when providing services as auditor; rather the nature of an independent auditor is that it will perform the services objectively and impartially."); *Wright v. Sutton*, CIV. A. 1:08-1431, 2011 WL 1232607, at *4 (S.D. W. Va. Mar. 29, 2011) ("In general, 'an accountant hired to audit the financial statements of a client is not a fiduciary of the client, but rather is required to be independent of the client.'"), *quoting TSG Water Resources v. D'Alba & Donovan Certified Public Accountants*, 366 F. Supp. 2d 1212, 1227 (S.D. Ga. 2004), *overruled on other grounds*, 260 Fed. Appx. 191 (11th Cir. 2007).

risk violating the regulatory framework described above. Faced with this dilemma, *amici* believe that many, if not most, CPA firms will choose simply to avoid potential liability altogether and decline to provide audit services to companies based in North Carolina. This is particularly true with regard to publicly-traded companies, as the penalties for violating the PCAOB and SEC independence rules include not only monetary fines, but the potential loss of registration and the ability to audit public companies. *See* 15 U.S.C. § 7215(c)(4); PCAOB Rule 5300.

The end result is that North Carolina organizations—and by extension the public—will lose access to audit services. Even if some CPA firms continue to perform audits in North Carolina, the third-parties who typically use and rely on those audits (e.g., financial institutions and shareholders) will no longer be able to do so because they will know that the auditor's independence is compromised. Although the Court of Appeals presumably believed that imposing a fiduciary duty on auditors would improve the accuracy and reliability of audits, in reality the opposite will occur. Accordingly, *amici* believe that the Court of Appeals' decision, if allowed to stand, will set a dangerous and harmful precedent.

II. THE COURT OF APPEALS ERRED IN REFUSING TO IMPUTE COMMSCOPE'S MANAGER'S FAILURE TO FILE TAX RETURNS TO COMMSCOPE.

The Court of Appeals' holding that a general manager's failure to file tax returns could not be imputed to the company is also contrary to well-established

law and undermines the auditor-client relationship. Auditors must be able to rely on a company's representations regarding its compliance with applicable accounting procedures and internal controls. Permitting a company to avoid responsibility for failing to follow its internal controls by shifting blame from its officers and directors to a negligent (or rogue) employee under their supervision will simply encourage such misconduct and, perversely, make it even more difficult for auditors to detect misfeasance.

A. Under Federal Law, CommScope Bears Responsibility for Filing Its Tax Returns.

CommScope admitted in its Complaint that its General Manager (Honeycutt) did not file Federal information returns from 2001 to 2009, which resulted in a penalty of $374,200. (R. 5 at ¶5). The Court of Appeals' holding that these allegations failed to "establish as a matter of law that Honeycutt's failure to file the tax forms may be imputed to Plaintiff" ignores not only North Carolina state law, but the Internal Revenue Code and established U.S. Supreme Court precedent.

Section 6033(a) of the Internal Revenue Code requires "[e]very organization exempt from taxation under section 501(a)"—which includes CommScope—to file an annual return. 26 U.S.C. § 6033(a). Section 6652(c) of the Code empowers the IRS to fine exempt organizations that fail to file Federal information returns, unless the organization can show that such failure was due to "reasonable cause." The U.S. Supreme Court has defined "reasonable cause" to mean "ordinary business

care and prudence." *See United States v. Boyle*, 469 U.S. 241, 246 (1985).[5] The Court in *Boyle* also noted that the duty to timely file taxes rested on the taxpayer, even if the taxpayer relied on the advice of an attorney or other professional agent—and that the reliance on an agent is not "reasonable cause" for a late filing. *Id.* at 250, 252.

Federal courts have uniformly read *Boyle* to mean that a corporation may not rely on its agents—including its employees—to excuse the corporation's failure to file a return. *See Valen Mfg. Co. v. United States*, 90 F.3d 1190, 1193 (6th Cir. 1996) (stating the non-delegable nature of the duty imposed upon taxpayers to comply with filing and payment requirements); *Conklin Bros. of Stanta Rosa, Inc. v. United States*, 986 F.2d 315, 317 (9th Cir. 1993) (recognizing that Congress has charged the corporate taxpayer "with an unambiguous duty" to file, and the corporation cannot avoid responsibility simply by relying on its agent); *Dogwood Forest Rest Home, Inc. v. United States*, 181 F. Supp. 2d 554, 561 (M.D.N.C 2001)

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[5] Although *Boyle* involved reasonable cause under § 6651(a)(1) of the Code, courts have routinely applied the same construction to the same term in § 6652(c). *See*, *e.g.*, *Del Commercial Props. v. Commissioner*, 251 F.3d 210, 218 (D.C. Cir. 2001) (stating that "[b]ecause the same terms are used in § 6651(a)(1) and 6656(a) to define the circumstances in which the taxpayer is not required to pay additions, we see no reason why "reasonable cause"… should not be interpreted consistently"); *Valen Mfg. Co. v. United States*, 90 F.3d 1190, 1193 n.1 (6th Cir. 1996) (stating that "[a]lthough Boyle involved only a § 6651(a)(1) violation, the language of the "reasonable cause" exception in §§ 6652(a)(2) and 6656(a) is identical and should be given the same construction").

(citing *Boyle* for the premise that reliance on agents does not excuse a taxpayer from penalties for late filings); *In re Frederick Savage, Inc.*, 179 B.R. 342, 346 (Bankr. S.D. Fla. 1995) (stating that the corporate taxpayer "cannot be excused from complying with the statutory requirements on the ground that it relied on one of its employees to fulfill those obligations").

The rationale of these decisions flows from the established principle that "[a] corporation can act only through its officers, agents, and employees." *State v. Pledger*, 257 N.C. 634, 637, 127 S.E.2d 337, 339 (1962). Given that practical reality, "the failure of a corporation to timely file tax returns or to timely make required tax payments or deposits almost invariably will be the result of the failure of one or more of the corporation's employees or officers to carry out his or her assigned duties." *Savage*, 179 B.R. at 347. "If an employee or officer's non-performance of duties was deemed to be reasonable cause, the IRS would rarely be able to impose tax penalties on a corporation." *Id.*

CommScope's complaint concedes that a) it failed to file Federal information returns for nine years in a row; b) the IRS assessed penalties in the amount of $374,200 with respect to that failure to file; and c) CommScope paid penalties assessed by the IRS, and thus did not establish reasonable cause. Accordingly, CommScope's complaint establishes that it violated *its* statutory requirement (and not the statutory requirement of the General Manager) to file its

tax returns for nine years, and that such violation was not excused by the IRS. As a matter of federal law, then, CommScope is responsible for its failure to file its tax returns.

B. The Court of Appeals Misapplied the "Adverse Interest" Exception to Imputation.

Despite CommScope's violation of its well-established duties under federal law, the Court of Appeals held that Honeycutt's failure to file the returns could not be imputed to CommScope as a matter of law because "the complaint certainly does not establish that Plaintiff expressly authorized Honeycutt's failure to file the tax forms nor that it ratified this omission after the fact." (Opinion at p. 15.) In reaching this conclusion, the Court of Appeals erroneously relied on the "adverse interest" exception to the general rule of imputation, concluding that, because Honeycutt's failure to file tax returns resulted in penalties to CommScope, his conduct could not have been in furtherance of CommScope's business. (*Id*. at p. 15-16, citing *Sparks v. Union Trust Co. of Shelby*, 256 N.C. 478, 482, 124 S.E.2d 365, 368 (1962)).

The Court of Appeals' conclusion misunderstands the nature of the "adverse interest" exception and effectively turns on its head the general rule of agency law that the acts of an agent are imputed to the principal. An agent's acts are not "adverse" to the company simply because they do not further the company's business or they result in harm to the company; if that were the case, then no

principal could ever be held liable for the negligence or carelessness of an agent. Rather, an agent falls within the adverse interest exception if it acts solely on its own behalf and for its own benefit. *See*, *e.g.*, *Sparks*, 256 N.C. at 482, 124 S.E.2d at 368 (declining to impute conduct to principal where agent engaged in "independent, fraudulent, and *ultra vires* transactions" that he intended to conceal); *Corporation Commission v. Bank of Jonesboro*, 164 N.C. 357, 79 S.E. 308 (1913) ("The knowledge of [agent], if material, would not be imputed to the [principal], *because he was acting in his own interest* and adversely to his principal.") (emphasis added). In this case, the Complaint does not allege that Honeycutt acted for his own benefit and on his own behalf in failing to file CommScope's tax returns, and the Court of Appeals erred in failing to impute his actions to CommScope.

C. The Court of Appeals' Holding on Imputation Further Undermines the Auditor-Client Relationship.

This Court of Appeals' holding on the issue of imputation—and its related conclusion that Butler & Burke's contributory negligence and *in pari delicto* defenses did not bar CommScope's claim—is of particular concern to *amici* because, as auditors, they must be able to rely on the representations of corporate management. Indeed, AICPA's Professional Standards require auditors to obtain written representations from management regarding, *inter alia*, the preparation and fair presentation of financial statements and identified or suspected non-

compliance with laws and regulations. *See* AU-C Section 580.[6] If a general manager's failure to file a tax return cannot be imputed to the company under North Carolina law—even when Federal law places the responsibility for filing on the company—then the auditor cannot rely on management's representations regarding violations or possible violations of laws or regulations. Under the Court of Appeals' decision, then, an auditor who issues an audit opinion based on a management representation that later turns out to be false runs the risk of bearing entirely what should be the corporation's liability. This concern is not hypothetical. To the contrary, the Court of Appeals' refusal to recognize Butler & Burke's *in pari delicto* or contributory negligence defenses confirms the very real risk that CPA firms will face in North Carolina going forward. This provides yet another disincentive for CPAs to provide audit services in North Carolina.

CONCLUSION

In sum, the Court of Appeals' decision significantly alters the dynamics of the auditor-client relationship and brings North Carolina law into conflict with both professional standards and State and Federal regulations. The Court of Appeals' holding on imputation also conflicts with well-established principles of agency law and will further damage the auditor-client relationship in North Carolina. If

[6] *Available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-C-00580.pdf.

allowed to stand, the Court of Appeals' decision will have a significant negative impact on North Carolina CPAs, North Carolina companies, and the public. Accordingly, for the foregoing reasons, and for the reasons set forth in Butler & Burke's opening brief, the Court should reverse the Court of Appeals' decision below and affirm the trial court's dismissal of CommScope's complaint.

Respectfully submitted this 6th day of April, 2015.

/s/ Brent F. Powell

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I certify that all of the attorneys listed below have authorize me to list their names on this document as if they had personally signed it.

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CERTIFICATE OF COMPLIANCE
WITH TYPEFACE AND WORD COUNT

Pursuant to Rule 28(j) of the Rules of Appellate Procedure, the undersigned certifies that the foregoing brief, which has been prepared using fourteen-point font, proportionally spaced type (Times New Roman), contains no more than 3,750 words, including footnotes and citations, as reported by word-processing software.

This 6th day of April, 2015.

/s/ Brent F. Powell
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CERTIFICATE OF FILING AND SERVICE

I hereby certify that the foregoing has been filed pursuant to Rule 26(a)(2) of the Rules of Appellate Procedure, and that on this 6th day of April, 2015, I served a copy of the foregoing **BRIEF OF AMICI CURIAE CHERRY BEKAERT LLP, CLIFTONLARSONALLEN LLP, AND DIXON HUGHES GOODMAN LLP IN SUPPORT OF DEFENDANT-PETITIONERS BUTLER & BURKE, LLP** upon the following person(s) by placing a copy in the U.S. Mail, postage prepaid and properly addressed to:

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