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NC Business Court Adopts “Audit State Rule” to Govern Choice of Law in Malpractice Claims Against Auditors

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In a recent decision, the North Carolina Business Court held that the law of the state where a financial audit is “performed, delivered and disseminated” governs auditor liability standards. As a result, in this case, the Business Court held that Pennsylvania law governs auditor liability rules in an audit of a Pennsylvania corporation performed by the Illinois auditing firm Grant Thornton through its accountants licensed in Pennsylvania. The North Carolina “audit state rule” is important to accountants, lenders and others who seek to rely on financial audits.

On April 20, 2009, in *Harco National Insurance Company v. Grant Thornton, LLP*, the North Carolina Business Court had to decide which state’s law governs an auditor’s (Grant Thornton, in this case) liability to third parties for negligence in the preparation of a company’s financial reports. This issue can be crucial in an auditor/accountant negligence case, because liability standards vary greatly from state to state. The court came down in favor of the law of the state where the audit was “performed, delivered and disseminated”-- the “audit state” rule. Although the decision is not binding on other North Carolina courts, it is likely to be persuasive, since the Business Court was created to specialize in complex business disputes.

In 2005, Harco National Insurance Company (“Harco”) sued Grant Thornton for negligence in auditing financial reports of Capital Bonding Corporation (“CBC”), a Pennsylvania company. The audits in question were conducted by Grant Thornton’s Philadelphia office by accountants licensed to practice in Pennsylvania. CBC provided the Grant Thornton audits to Harco during the course of Harco’s due diligence before entering into an agreement with CBC. Harco claimed that it relied on Grant Thornton’s audits in deciding to enter into this agreement.

The ultimate question in the case was whether an auditor owes a duty to a third party like Harco that does not have a direct relationship with the auditor, but relies on the audited financial reports before entering a transaction with the auditor’s client. Grant Thornton argued that Illinois law should decide this question because it is an Illinois limited liability partnership and Harco has substantial contact with Illinois, including

the location of its home office and supervision by Illinois regulators. Harco argued that the more plaintiff-friendly North Carolina law should govern for several reasons. First, there was substantial economic impact on North Carolina as Harco paid more losses in North Carolina than in any state other than New Jersey. Second, McM Corporation (“McM”), an affiliate of Harco, is a North Carolina company and McM employees who are residents of North Carolina made the decisions related to Harco’s agreement with CBS.

Illinois has a defendant-friendly “near privity” rule that requires a plaintiff to show that it was the “primary intent of the client” that the audit benefit or influence “the particular person bringing the action.” North Carolina, in contrast, follows a more plaintiff-friendly rule. It requires a plaintiff to show only that the auditor knew and intended that the plaintiff *or a class of entities that includes the plaintiff* would rely on the audit, or that the auditor knew that the client intended for that entity or class of entities to so rely. This rule does not require that the audit firm know of the specific third party or take any action to extend the benefits of the audit to a third party if that third party is within the class of intended beneficiaries. A creditor of a company that relied on the audited financial statement to extend credit to the company, for example, could fall within the class of intended beneficiaries, even if the audit firm was not specifically aware of this third party. The North Carolina rule, therefore, makes it more difficult for an auditing firm to limit the scope of its liability to third parties.

Application of the strict Illinois standard to the facts of the case would have resulted in summary judgment in favor of Grant Thornton (an early dismissal of the plaintiff’s claim), while the case would have gone forward to trial under North Carolina law. This stark difference in outcomes highlights the practical importance of choice of law questions. Following the universal practice, the Business Court applied its home-state (North Carolina) choice of law rules. These rules directed the court to reject the positions of both parties and apply Pennsylvania law. The court noted that Pennsylvania’s law is currently unclear and directed briefing on the issue.

North Carolina’s choice of law rules emphasize public policy concerns and the need for clarity, certainty and consistency. The Business Court found that the state where the audit occurred has the most significant public policy interests at stake. Those interests include setting the performance and liability standards for auditors in the state and protecting the well-being of local companies being audited. The court also noted that the state where the audit is performed is where the costs are borne.

The court also determined that the audit state rule would increase clarity, certainty and consistency for the auditing profession and those relying on its work. This rule allows accountants to do risk analysis and set prices with greater certainty, thus reducing transaction costs and lowering the overall cost of auditing services. Additionally, businesses relying on the audits will have greater certainty with respect to their rights against the auditor if the audit is negligently performed.

The court explained how the parties’ preferred criteria for deciding which state’s law to apply (the state of the home office of the party relying on the audit, the state where the insurance proceeds were first paid, or the state in which the injury occurred) would result in inconsistent, random, unpredictable and uneven outcomes depriving parties of the ability to project risk and price transactions. The court also rejected choosing the law of the state of incorporation of the accounting firm even though that would provide certainty as to the applicable law. The court believed this approach ignores the reality that most of the work is done in the local office, not the home office, and would produce inconsistent and unequal results for the same work conducted in the same state by two different firms whose home offices happened to be in two different states.

The Business Court's application of the audit state rule is significant to any business in North Carolina that relies on audited financial statements in assessing whether to enter a transaction. Even if the transaction is based in North Carolina, application of the audit-state rule means that North Carolina law will not govern auditor liability if the audit was conducted in another state. Affected businesses and their counsel must familiarize themselves with the law of the audit state to determine the level of protection afforded. Furthermore, businesses that obtain audits in North Carolina should be aware that their auditors are now subject to North Carolina's more pro-plaintiff standard of auditor liability (as compared to Illinois and New York and other states that apply the "near privity" test), and may raise their fees accordingly.

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