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The Engineer's Naming of Owner as Additional Insured Not Blocked by Professional Services Exclusion

Patrick Engineering, Inc. v. Old Republic Gen.l Ins. Co., 2012 IL App (2d) 111111 (July 20, 2012)

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. . . the appellate court viewed the carrier's arguments as if the carrier were looking into the telescope from the wrong direction: an exclusion neither trumps the separation-of-insureds clause nor overcomes the usual rules of interpretation of liberal construction and how the "arising" language will support nearly any factual link of causation.

Owners/clients often ask their architect/engineering (A/E) firms, like contractors, to add the client as additional insureds to the A/E firm's general liability (GL) policy. Those GL policies invariably have a "professional acts" or professional-services exclusion. If the additional insured tenders its defense but the carrier disclaims, the A/E firm can face a breach of contract action for failing to procure the requisite coverage. If the additional insured is successful on that failure to procure claim, the damages may encompass the defense and indemnity amounts paid by the putative additional insured as a breach.

In a typical case, accidents might lead to the A/E firm, the additional insured client, and contractors all being sued. While the A/E firm may be defended under its professional liability policy, will the additional insured be defended under the A/E firm's GL policy? Might the GL carrier invoke the "professional acts" exclusion?

The Illinois Appellate Court, Second District, recently considered what extent defendant GL carrier could raise the professional acts exclusion to bar a duty to defend the additional insured client. The carrier had obtained summary judgment in the trial court based on the exclusion. Plaintiffs were an engineering firm and a power company, the firm's additional insured-client. The appellate court was called upon to reconcile the power company's status under the exclusion and the separation-of-insureds clause, while applying the usual rules of construction for policies and their exclusions.

By contract the engineering firm agreed to provide and maintain GL coverage naming the power company as an additional insured. The power company directed the engineering firm to design the relocation of its utility poles in the village of Lombard, Illinois. In performing the work, the power company "smashed through an underground sewer facility on at least four separate locations." The village sued the power company, alleging negligence. The power company tendered its defense to the carrier as an additional insured, and the carrier denied coverage, raising the professional-services exclusion. The power company also tendered its defense to the engineering firm. In the eventual declaratory judgment claim of the carrier, the power company brought a third-party complaint against the engineering company for failure to procure.

The carrier asserted in its denial letter that its endorsement provided coverage for the putative additional insured arising out of the engineering firm's work. Because the engineering firm "confirmed" that it had performed only engineering work, the carrier asserted the professional-services exclusion acted to disclaim coverage for the power company and the engineering firm.

The power company argued that it had not been performing professional services and thus should be covered under the GL policy. The carrier countered that because the damage arose in part out of the engineering firm's professional services, the professional-services exclusion barred coverage for the power company. The power company replied that the separation-of-insureds clause meant that its coverage was to be determined independently of the engineering firm. Because the damage also arose from the power company's nonprofessional labor services, the power company argued that the professional-services exclusion should not bar coverage.

The appellate court ruled that the power company could rely on the "arising-out-of-[the engineering firm's]-work" language in the additional insured endorsement to claim status as an additional insured — even though the engineering firm's work was professional — and then rely on the separation-of-insureds clause to claim coverage for its own nonprofessional role.

In so reasoning, the appellate court noted that because the duty to indemnify arises only if facts alleged "actually fall" within coverage as distinguished from the broader scope of a duty to defend, an exclusion may bar the duty to indemnify only where the application of the exclusion if "clear and free from doubt." The court considered several other reported decisions in reaching its result. It also rejected the carrier's contention that "the professional-services exclusion in those cases did not refer expressly to the named insured by stating that damage arising out of professional services 'by [or for] you' are excluded."

The carrier also argued that any property damage that arose out of the engineering firm's professional services is not covered by the policy. The appellate court disagreed, determining that under that "interpretation of the policy, if [the engineering firm's] rendering of professional services played even a minute causal role in the damage, no insured would be covered under the policy."

The carrier also asserted that the power company was not an additional insured because the damage arose simply from the power company's own negligence with no connection to the engineering firm's work. The appellate court disagreed, noting that Illinois case law holds that "*any* causal connection between [the engineering firm's] work and the liability is sufficient to establish [the power company's] status as an additional insured." The appellate court reminded all that policies are to be liberally construed in favor of the insured (additional or named).

In effect, the appellate court viewed the carrier's arguments as if the carrier were looking into the telescope from the wrong direction: an exclusion neither trumps the separation-of-insureds clause nor overcomes the usual rules of interpretation of liberal construction and how the "arising" language will support nearly any factual link of causation.

Comment

A/E firms would routinely face failure-to-procure breach of contract actions if the carrier's arguments in *Patrick Engineering* had been upheld. Endorsements using the "arising out of" language will be construed very broadly with only the slightest of factual linkage required.

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Recent Court Rulings

Accountants

Accountant's Legal and Ethical Advice Does Not Result in Damages, Since the Measure of Damages Is Based Upon Properly Filed Taxes

***RTR Technologies, Inc. v. Helming,* 815 F. Supp. 2d 411 (D. Mass. 2011)**

The U.S. District Court for the District of Massachusetts recently found that defendant accountant's advice, although resulting in tax liability, did not cause damages because plaintiff owner's (the owner's) purported loans to herself from a second plaintiff, her Subchapter S corporation (the corporation), were actually properly categorized as income and thus subject to income taxes. The court also held that Massachusetts' three-year statute of limitations applicable to professional malpractice claims governed this case based upon the "essential nature" of plaintiffs' claims. *See* Mass. Gen. Laws ch. 260, § 4.

The corporation was incorporated in Massachusetts in 1994. Its sole owner was the owner and its sole employee was the owner's husband, who was also a plaintiff in the case. From 1994 to 2003, the owner withdrew varying sums of money from the corporation's accounts, recording such withdrawals as "Loan to Officer" in the corporation's books. As of December 2002, more than $1 million had been recorded as Loans to Officer. Additional sums were recorded as loans to other companies that were owned by the owner and/or her husband.

After the September 11, 2001 terrorist attacks, the need for the corporation's products dwindled. The corporation became financially troubled, and it applied for several loans from the Small Business Administration (SBA). Several loans were ultimately approved around 2002.

By 2003, the corporation was unable to repay those loans, and it entered into a forbearance agreement with the SBA that required it to employ a turnaround manager to help recover from its financial difficulties. The agreement also barred loans to any related individuals or entities, including the owner, her husband and their companies. That agreement was extended several times, and it was valid at least through July 2005.

Both the SBA and the turnaround management firm hired by the owner in 2003 saw the loans to the owner from the corporation as key factors in the corporation's downfall. For example, the turnaround management firm opined that, had the corporation retained even a portion of the monies it loaned to the owner, its financial circumstances would have been markedly improved. It also noted that recovery of those loans and loans to companies owned by the owner and her husband was doubtful. By September 2003, the turnaround management firm had concluded that it would be in the corporation's interests to limit the owner's involvement with the company. Upon that report, the owner fired the turnaround management firm and hired defendants: (1) a business consulting and public accounting firm (the firm) with its principle place of business in Connecticut; and (2) the president of the business consulting and public accounting firm (the firm's president), who was certified public accountant, turnaround professional, insolvency reorganization advisor, and valuation analyst. An agreement was entered to this effect between the parties.

The firm was ultimately retained to provide both turnaround advice and tax services. The firm's president also became concerned about the Loans to Officer and opined that because the loans could not be collected, it was improper to treat them as "loans." He recommended that the loans, which were reported as loans in plaintiffs' personal and corporate tax returns for 2002, be re-classified as income. Defendants' recommendation was based on: (1) the potential for a lawsuit against plaintiffs' previous accounting firm; (2) the need to clean up records for the SBA; and (3) the need to maintain accurate balance sheets as turnaround managers. The firm's president explained several times in 2004 and 2005 to the owner and the corporation's general manager that the loans were not bona fide, in large part because they likely would never be recoverable.

On April 12, 2005, the firm's president provided to the owner a formal explanation of his belief that the Loan to Officer was not a bona fide loan and that plaintiffs faced tax liability. Unhappy with defendants' conclusions, the owner sought the advice of two tax attorneys, one of whom expressed concerns similar to defendants'. The other attorney rendered no opinion.

On December 3, 2005, the owner, acting as president of the corporation, signed amended tax returns prepared by the firm's president that re-characterized her purported "loans" as "income." The U.S. Internal Revenue Service (IRS) accepted this as well as initial personal and corporate filings prepared by the firm's president for 2003, 2004 and 2005, all denoting the loans as income to the owner. As a result of the 2002 amendment, the corporation went from showing a net profit of around $16,000 to a net loss of approximately $1.5 million for that year. A federal tax lien was also entered against the owner and her husband on July 16, 2006 for $526,014.55 as a result of the increased income. Defendants worked for plaintiffs until 2008.

On October 1, 2008, plaintiffs filed re-amended 2002 corporate and personal tax returns with the assistance of a new accountant, denoting the approximately $1 million received by the owner as loans once again. The IRS accepted the re-amendment and withdrew its tax lien against the owner and her husband. Plaintiffs never amended their 2003, 2004 or 2005 returns.

Plaintiffs subsequently sued, alleging that defendants negligently advised them with respect to the "Loan to Officer" account, resulting in damages including tax liability, costs associated with accounting remediation, loss of goodwill, loss of loans, incursion of unnecessary supply costs as a result of the need to buy supplies from outside vendors, lost profits, lost incremental revenue damages, and lost margin damages, *i.e.*, monies paid to defendants. Defendants moved for summary judgment, contending that the owner's claim was time-barred and that the owner suffered no damages.

The court noted that the allegedly tortious conduct occurred between December 2005 and January 2006, and that plaintiffs filed their action on October 8, 2009. Plaintiffs contended that the six-year statue of limitations governing breach of contract claims should apply, premised upon the employment agreement entered into between the parties at the commencement of their relationship. Defendants contended that the three-year statute of limitations applicable to professional malpractice claims should apply. In looking at the "essential nature" of plaintiffs' action, the court held that the crux of their claim was professional malpractice by a certified public accountant. Permitting plaintiffs to rely on the underlying employment agreement would undermine and essentially eliminate the three-year statute of limitations because most malpractice claims involve some underlying employment agreement. As such, the court held that the three-year statue of limitations applied.

Moreover, the court held that, given the owner's actual conversations with other attorneys, she had investigated defendants' advice in 2005 and was thus well aware of the circumstances. In fact, she had expressed great concern about defendants' advice well before October 8, 2006 (three years prior to the date she filed her action). The owner was therefore on inquiry notice, and the statute of limitations began to run, at the latest, on July 16, 2006, when the IRS assessed its tax lien. By that date, plaintiffs knew or should have known of the harm (the tax lien) and who caused it (defendants). Accordingly, because plaintiffs filed their action on October 8, 2009, all their claims were time-barred.

Case Summaries & Conclusions

The court also noted that defendants' legal and ethical advice, although resulting in a tax lien, did not cause damages because the purported loans were shams. In other words, plaintiffs were unable to show that defendants' approach caused them to incur additional tax liability above and beyond what they otherwise would have faced under the law. No experts opined that the "loans" at issue were indeed loans. Defendants' advice to plaintiffs, as a matter of "prudence, ethics, and law," was perfectly correct. Moreover, given the tax treatment of Subchapter S corporations, defendants' advice only shifted the liabilities between the owner — the corporation's sole owner — and the corporation. Similarly, plaintiffs' other claims for damages, such as loss of potential business, were speculative at best.

Accordingly, the court granted defendants' motion for summary judgment.

Comment

This decision demonstrates that: (1) although claims of malpractice often sound in tort and contract, their essence will often render them governed by the statute of limitations applicable to tort claims or, where applicable, more specific malpractice statutes; and (2) although legal and ethical advice may result in tax liabilities, such liabilities do not constitute damages where they are tax liabilities for which the plaintiff was properly obligated under the law.

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Accountants

Delayed Discovery Rule Not Applicable to Toll Statute of Limitations Where Officer of Company Knew of Facts Suggesting Potential Negligence.

***Robert Czajkowski v. Haskell & White, LLP*, No. D059090, 2012 WL 2914289 (Cal. Ct. App. July 18, 2012)**

The California Court of Appeal, Fourth District, issued an opinion limiting the conditions under which the statute of limitations for malpractice causes of actions brought against accounting firms may be tolled. The court held that Cal. Code Civ. Proc. § 339, subd. 1, which imposes a two-year limitation period for "[a]n action upon a contract, obligation or liability not founded upon an instrument of writing . . . [,]" is tolled only until facts sufficient to arouse the suspicions of a reasonable person come to a plaintiff's attention.

Plaintiff was a company's chief executive officer (CEO) from September 2001 to September 2002. The company retained defendant accounting firm to audit its financial records for 2001 and 2002. The accounting firm's agreement with the company obligated the firm to reasonably inform the company of errors, fraud, illegal acts, or reportable conditions. Pursuant to that agreement, the accounting firm prepared and delivered audit reports to the company and the CEO in his official capacity. No relevant irregularities were noted in those reports.

In August 2002, the CEO learned that the company's chief financial officer (CFO) had, since 2001, diverted company funds that were meant for payroll taxes. Around the same time, due to the resulting payroll tax liabilities, the company was forced to close down.

The state of California subsequently sought to hold the CEO personally liable for the unpaid payroll taxes. During the state's investigation, the CEO reviewed the accounting firm's reports and was aware that any irregularities should have been noted in footnotes of those reports. The reports did not note any irregularities. The state's investigation ultimately concluded that the CEO was unaware of CFO's illegal activities until August 2002. The state accordingly released its claims against the CEO.

In 2006, the IRS instituted its own proceedings against the CEO, who ultimately settled in 2009 by paying the IRS more than $500,000. In June 2008, the IRS subpoenaed the accounting firm's records, which the CEO received at around the same time.

In March 2010, the CEO sued the accounting firm, claiming professional negligence. The CEO alleged that the accounting firm should have discovered the CFO's illegal activities and the corresponding tax liabilities and noted them in its reports to the company. The CEO further alleged it was not until after June 2008 that he first learned of the accounting firm's professional negligence because the accounting firm purposefully concealed its working papers and indications of wrongdoing from the CEO until 2008, when such records were subpoenaed by the IRS and revealed to him. The CEO alleged that the first time he knew or could have known about the accounting firm's negligence was in 2008 and, as such, the two-year statue of limitations should be tolled until June 2008, making his March 2010 complaint timely under the two-year statute of limitations. The trial court found the CEO's causes of action time-barred.

The Court of Appeal held that California's delayed discovery rule tolls applicable statutes of limitations where plaintiffs allege that fraudulent concealment prevented their earlier discovery of the alleged negligence. When relying on this rule, plaintiffs must plead: (1) the time and manner of discovery of previously unknown information (which must be within two years of the filing of the action at issue); and, (2) the inability to earlier have made the discovery despite reasonable diligence. When facts are sufficient to raise suspicion that "professional blundering" has occurred, potential plaintiffs (*i.e.*, clients) have the duty to investigate such claims. The potential existence of any fiduciary relationship does not interfere with the independent duty to investigate upon learning of suspicious facts. As applied, these standards take into account a plaintiff's sophistication.

Here, the court noted that the CEO knew by 2002 that the CFO had swindled company money meant for taxes. Based on this alone, the court held that a reasonable executive should have reasoned that professionals charged with the company's finances, including the accounting firm, may have played a role in the company's failure to detect the CFO's illegal activities. At the least, once the company was forced to shut its doors the same year as a result of tax liabilities, the CEO should have caught on to the accounting firm's potential negligence. The court also noted that the CEO spoke with a representative of the accounting firm in 2005, and that the representative told the CEO where any irregularities *should* have been noted in the report, if any were discovered. The court found the CEO's claim that he did not discover the accounting firm's negligence until 2008, when he received records subpoenaed by the IRS from the accounting firm, unavailing because information revealed to the CEO in 2008 could not in anyway be considered "hitherto unknown information."

As such, the Court of Appeal dismissed the appeal.

Comment

This decision emphasizes that plaintiffs may not sit idly by in the face of a potential professional negligence claim, relying upon later arguments that they were prevented from discovering the potential negligence as fiduciaries of professionals. Clients have a duty to investigate potential claims as soon as they become aware of facts suggesting negligence.

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Engineers

Colorado Economic Loss Rule Bars Lender's Tort Action Against an Engineer That Issued a Report As to the Viability of a Coal Mine to Another Lender

***Standard Bank, PLC v. Runge, Inc.*, 443 Fed. Appx. 347 (10th Cir. 2011)**

The U.S. Court of Appeals for the Tenth Circuit issued an opinion holding that defendant engineering firm had no duty to plaintiff bank independent of its contract to provide an accurate evaluation of a coal mine, which ultimately failed. Citing *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66 (Colo. 2004), the Tenth Circuit determined that the economic loss rule barred the bank's tort claims based on the interrelated contracts of the commercially sophisticated parties contractually allocating risk.

The bank sued the engineering firm for negligent misrepresentation and professional negligence, alleging that the firm prepared a flawed viability report in connection with a buyer's purchase of a coal mine in Indiana for $25 million. A second lender had originally planned to provide financing and directed the firm to contact the buyer for an independent evaluation of the mine.

The buyer retained the engineering firm as an independent engineer and paid it $35,000 in connection with the retention agreement. Pursuant to the agreement, the engineering firm was required to evaluate the coal mine in accordance with the standard of care in the profession, but limited the engineering firm's total liability to the greater of the fees paid under the contract or $50,000. The agreement further stated that no third-party beneficiaries were intended, and any party that disclosed the contents of the report needed permission from the other party prior to disclosure. The final report also indicated that the engineering firm prepared the report for the second lender in its evaluation of the mine.

The second lender backed out the day before the deal closed and the bank stepped in to provide financing. The bank also required an evaluation from an independent engineer. The engineering firm produced a report to the bank that was nearly identical to the report for the second lender, but the recitals were amended to indicate that the report was intended for the bank in connection with its evaluation of the buyer's project. The buyer's acquisition of the mine closed in December 2005.

By March 2006, serious problems with the mine became evident and the bank alleged that the issues should have been identified in the engineering firm's report. The mine failed and the buyer declared bankruptcy in May 2006. The bank sued the engineering firm for the allegedly defective evaluation. The U.S. District Court for the District of Colorado granted summary judgment in the engineering firm's favor based on the economic loss rule.

Colorado adopted the economic loss rule in *Town of Alma v. AZCO Construction*, 10 P.3d 1256, 1264 (Colo. 2000), which prohibited a party suffering only economic loss based on the breach of an express or implied contract from asserting a tort claim for such a breach absent an independent duty of care. The scope of the economic loss rule also includes third-party contract beneficiaries. The *Town of Alma* court denied the tort claims of the plaintiffs in that case based on the duties stated in the construction contract.

Colorado expanded the economic loss rule to include commercial cases in *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66 (Colo. 2004). In *BRW*, a subcontractor on a municipal construction project attempted to sue the project's engineer for negligence and negligent misrepresentation based on allegedly faulty plans that allegedly increased the subcontractor's costs. Despite the absence of a contract between the subcontractor and the engineer, *BRW* expanded the economic loss rule because the rule "applies when the claimant seeks to remedy only an economic loss that arises from interrelated contracts." The *BRW* court rejected the subcontractor's tort claims because the duties arose in contract and the project "involved commercially sophisticated parties able to negotiate and bargain for an allocation of risks, duties and remedies."

The Tenth Circuit in *Standard Bank* relied heavily on *BRW* and found that the relationship between the engineering firm and the bank was governed by a set of interrelated contracts between sophisticated entities that had the opportunity to allocate risk. The bank could have, for example, negotiated with the buyer to transfer more risk to the engineering firm or negotiated with the engineering firm to have the bank named as an additional insured on the professional liability policy.

The court also declined to limit the economic loss rule to only construction cases as in *BRW*, and did not require the interrelated contracts be negotiated contemporaneously, or even prior to the work. Importantly, the court also refused to establish a duty of care on engineers if that duty is recited in the contract. In doing so, the court identified three factors from *BRW* to determine the source of the duty: (1) whether the relief sought in negligence is the same as the contractual relief; (2) whether there is a recognized common law duty of care in negligence; and (3) whether the negligence duty differs in any way from the contractual duty. The court found that the bank alleged that the engineering firm breached the very duty recited in the contract – the duty to provide professionally competent services – and declined to apply an independent duty of care on engineers if that duty is recited in the contract.

The court rejected all of the bank's arguments based on the bank simply trying to skirt liability for its lack of diligence. The Tenth Circuit therefore held that the economic loss rule barred the bank's claims and that the engineering firm's liability was limited to its liability under the contract.

Comment

In Colorado, the economic loss rule will be interpreted expansively in favor of professionals in cases involving interrelated contracts between commercially sophisticated entities that have the opportunity to allocate risk and loss. Although Colorado extends the economic loss rule to both informational and design professionals, some jurisdictions recognize an exception to the rule where the engineer provides only an informational report and no design work. *See* Restatement (Second) Torts § 552.

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