RECENT DEVELOPMENTS AFFECTING PROFESSIONALS', OFFICERS', AND DIRECTORS' LIABILITY INSURANCE

Daniel S. Strick, Glen Olson, Ari Baruth, Mark Rogers, Margaret Reetz, David Hommel, Peter J. Biging, Michael Chester, Susan Cohen, and Timothy Pomarole

Daniel S. Strick (dstrick@lucascavalier.com) is a partner with Lucas and Cavalier, LLP. Glen Olson (golson@longlevit.com) is a partner and Ari Baruth (abaruth@longlevit.com) is senior counsel with Long & Levit LLP. Mark Rogers (mrogers@carlockcopeland.com) is a partner with Carlock Copeland. Margaret Reetz (margaret.reetz@mendes.com) is a partner with Mendes and David Hommel (david.hommel@mendes.com) is an associate. Peter J. Biging (pbiging@goldbergsegalla.com) is a partner with Goldberg Segalla. Michael Chester (mchester@skarzynski.com) is a principal with Skarzynski Black. Susan Cohen (scohen@peabodyarnold.com) is a partner with Peabody & Arnold LLP. Timothy Pomarole (tpomarole@peabodyarnold.com) is of counsel with Peabody & Arnold LLP.

I. INTRODUCTION

This article discusses recent noteworthy court decisions and regulatory actions affecting the liability that a variety of professionals—including corporate directors and officers, architects and engineers, lawyers, accountants and auditors, and insurance agents and brokers—may incur to third parties or for which they may seek insurance coverage. Section II of the article addresses developments in directors and officers insurance coverage over the past year, including courts' divergent conclusions about coverage available for regulatory investigations and the application of the prior acts exclusion to post-policy claims purportedly arising out of pre-policy wrongful acts. Section III turns to recent developments in the specific area of professional liability claims involving architects, engineers, and other design professionals. These developments examine the extent to which these professionals are obligated to defend an owner, developer, or general contractor for that party's own negligence, and whether the design professionals may escape liability for damages that are solely economic in nature under the "economic loss doctrine." Section IV discusses developments in legal malpractice cases and highlights a case in which a legal malpractice claim was dismissed for failure to adequately plead harm from the representation. It also addresses recent decisions regarding the discoverability of successor attorney files in malpractice cases. Section V presents developments in the specific area of accounting malpractice, including cases addressing the extent to which a non-party to an accounting agreement may seek damages from the accountant, the effect of state law on arbitrability, and whether engagement letters may contractually alter the applicable statutes of limitations. Finally, Section VI discusses developments over the past year in insurance broker and agent liability, examining varied topics such as when a "special relationship" exists between a policyholder and its agent or broker that imposes fiduciary or similar duties on the agent or broker, the interplay of statutes of limitations with the policyholder's duty to read its policy, and the grounds for a negligent misrepresentation claim by a broker against the underwriting insurance company.

II. Directors' and Officers' Liability Insurance Coverage

This survey period included some particularly interesting and instructive rulings for directors and officers (D&O) liability insurance coverage practitioners. While many D&O insurance policies are interpreted by trial courts, appellate review of such decisions is far rarer. In 2017, two of the more prominent rulings of interest to D&O practitioners were issued by circuit courts of appeal. In *MusclePharm v. Corp. v. Liberty Insurance Underwriters, Inc.*,[1] the Tenth Circuit addressed the question of whether a subpoena or private order of investigation by a regulatory agency constitutes a claim under the terms of a D&O policy; and in *Zucker v. U.S.*

1. 2017 WL 4675701 (10th Cir. Oct. 17, 2017).

Specialty Insurance Company,[2] the Eleventh Circuit addressed the question of whether a prior acts exclusion bars coverage for a claim "arising out of" wrongful acts committed before the inception of the policy. These two appellate cases, their facts, and other recent decisions involving the same issues are discussed in detail below.

A. *Regulatory Investigations and Subpoenas*

Any attorney practicing in the D&O arena knows one of the trickiest and most detail-oriented issues is the question of whether a regulatory investigation or the receipt of subpoenas issued by a regulatory agency qualifies as a valid "claim" under a D&O policy. Many insurers will offer enhanced language by endorsement that is designed to address coverage for such events. However, regardless of whether the issue is specifically addressed via endorsement, insurers and insureds can find themselves at odds. Moreover, insurers and insureds may find themselves arguing either side of the issue depending on the particular facts of a matter and the approach that will help them avoid or maximize coverage, respectively. Two courts on opposite sides of the country recently examined whether an SEC investigation constitutes a "claim" under a D&O policy and arrived at very different conclusions. Given the different facts and postures of the cases, however, the insurer prevailed and avoided coverage in both cases.

1. *MusclePharm Corp. v. Liberty Insurance Underwriters, Inc.*

In *MusclePharm*, the Tenth Circuit denied coverage to a policyholder that received an informal information request from the SEC, which eventually led to a full-blown formal SEC investigation.[3] The court found that the informal investigation did not rise to the level of a "claim" under the relevant D&O policy because it did not allege specific wrongdoing by the insured.[4]

The facts underpinning the *MusclePharm* case are as follows: policyholder MusclePharm Corp. received a letter from the SEC on May 16, 2013, stating that the SEC was "conducting an inquiry into MusclePharm and requesting that MusclePharm voluntarily produce documents."[5] Significantly, the SEC's letter stated that "[t]his inquiry is non-public and should not be an indication that the Commission or its staff believes any violation of the law has occurred, nor should you consider it an adverse reflection upon any person, entity, or security."[6] A few months after informally seeking information from MusclePharm, the SEC issued an "Order

2. 856 F.3d 1343 (11th Cir. 2017).
3. 2017 WL 4675701, at *2–3, *5.
4. *Id.* at *5.
5. *Id.* at *2 (internal quotations omitted).
6. *Id.*

Directing Private Investigation and Designating Officers to Take Testimony" against MusclePharm (Order) on July 8, 2013.[7] The Order indicated MusclePharm appeared to have violated securities laws, and the SEC would conduct a private investigation to evaluate the extent of any potential misconduct.[8] The Order also empowered the SEC to issue subpoenas, take depositions, and require the production of documents.[9] In accordance with this Order, the SEC subsequently issued twenty-one separate subpoenas to MusclePharm and its directors and officers requesting both the production of documents and in-person testimony.[10]

MusclePharm gave its insurer Liberty Insurance Underwriters, Inc. notice of both the informal request and the Order. MusclePharm first provided notice of the SEC's informal letter request a month after receiving it, weeks before the SEC decided to initiate a formal investigation.[11] Thereafter, MusclePharm also provided notice of the SEC's Order. Liberty denied coverage for both submissions on September 18, 2013.[12] However, Liberty did agree to accept the submissions as a notice of potential claim circumstances.[13]

Meanwhile, the SEC's investigation continued in earnest. In early 2015, the SEC issued Wells Notices to two individuals who served as MusclePharm's current and former chief financial officer.[14] The Wells Notices stated that the SEC had made a preliminary determination to commence an enforcement action against those individuals.[15] MusclePharm notified Liberty of the Wells Notices shortly after they were received in early 2015.[16] In response, Liberty stated that the Wells Notices qualified as a "claim" under its policy and that it would cover defense costs incurred by MusclePharm subsequent to its receipt of the Wells Notices.[17] Six month later, the SEC reached a settlement with MusclePharm and the individuals, resulting in the entry of cease-and-desist orders.[18]

The definition of "claim" in MusclePharm's policy included three key components relevant to coverage for the SEC's investigation: "(a) a written demand for monetary or non-monetary relief against Insured Persons, or with respect to Insuring Agreement 1.3, against [MusclePharm]; including

7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.* at *3.
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*

a request to toll the statute of limitations; . . . (c) a formal administrative or regulatory proceeding against an Insured Person; and (d) a formal criminal, administrative, or regulatory investigation against an Insured Person when such Insured Persons [sic] receives a Wells Notice or target letter in connection with such investigations."[19] As stated above, Liberty took the position that the "claim" did not ripen until the SEC issued the Wells Notices and satisfied subsection (d) of the definition.[20]

The day before MusclePharm received the Wells Notices, however, it had filed a declaratory judgment action against Liberty, alleging breach of contract and statutory and common law bad faith.[21] MusclePharm alleged that the SEC's investigation into MusclePharm constituted a "claim" under its policy as of May 16, 2013, the day MusclePharm first received any correspondence from the SEC.[22] MusclePharm also asserted it incurred over $3 million of expenses in the course of defending itself and honoring its indemnification obligations, and that Liberty was duty-bound to provide coverage for all defense costs incurred with any SEC activity.[23] Liberty removed the case to the U.S. District Court for the District of Colorado, and both parties filed cross-motions for summary judgment.

The district court concluded that the SEC's investigation did not satisfy the definition of "claim" in Liberty's policy prior to the Wells Notices being issued and therefore granted Liberty's motion for summary judgment, denied MusclePharm's motion, and dismissed the case.[24] MusclePharm appealed.

The Tenth Circuit affirmed the ruling of the district court denying coverage to MusclePharm and rejected MusclePharm's contention that the subpoenas issued by the SEC qualified as a "claim" because they constituted "a written demand for monetary or non-monetary relief."[25] Because the term "relief" was not defined by Liberty's policy, the Tenth Circuit examined the dictionary definition of that term: "'legal remedy or redress'" or the 'redress or benefit,' especially 'equitable in nature (such as an injunction or specific performance), that a party asks of a court.'"[26] However, the Tenth Circuit noted the SEC's Order specifically stated its investigation

19. *Id.* at *1.
20. *Id.* at *3.
21. *Id.*
22. *Id.*
23. *Id.*
24. Musclepharm Corp. v. Liberty Ins. Underwriters, Inc., No. 15-CV-00555-REB-KMT, 2016 WL 4179784 (D. Colo. Aug. 4, 2016).
25. Musclepharm Corp. v. Liberty Ins. Underwriters, Inc., 2017 WL 4675701, at *5 (10th Cir.).
26. *Id.* (citing Merriam-Webster, https://www.merriam-webster.com/dictionary/relief; BLACK'S LAW DICTIONARY (10th Ed. 2014).

was being conducted to determine whether there was any relief to seek.[27] The court also noted the SEC's letter and the Order specifically cautioned the SEC had not made a determination that any party had violated any law.[28] Accordingly, the court held the subpoenas could not constitute a written demand for monetary or non-monetary relief.[29]

The Tenth Circuit also rejected MusclePharm's argument that the SEC's Order commencing a private investigation qualified as a "formal administrative or regulatory proceeding" under the policy's definition of a "claim."[30] Looking again at the plain meaning of the terms "investigation" and "proceeding," the Tenth Circuit concluded that "'proceeding' is '[t]he regular and orderly progression of a lawsuit, including all acts and events between the time of commencement and the entry of judgment,' or '[a]ny procedural means for seeking redress from a tribunal or agency.'"[31] Likewise, the Tenth Circuit determined that an "investigation" was "'[t]he activity of trying to find out the truth about something.'"[32] Because the Order specifically stated that it was attempting to determine *whether* any person or entity had engaged in wrongdoing, the court concluded that the SEC's private investigation did not constitute a "formal or administrative regulatory proceeding" sufficient to qualify as a "claim" under Liberty's policy.[33] The Tenth Circuit also concluded that because of the cautionary language in the SEC's Order noted above, it also contained no specific "allegation" of wrongdoing against MusclePharm or any of its directors or officers.[34]

2. *Patriarch Partners, LLC v. AXIS Insurance Company*

In contrast to the Tenth Circuit decision in *MusclePharm*, Judge Valerie Caproni of the Southern District of New York applied a different analysis in *Patriarch Partners, LLC v. AXIS Insurance Company*.[35] Notably, the *Patriarch* decision predates *MusclePharm* by a few weeks.

In *Patriarch*, Judge Caproni ruled that an SEC formal order of investigation, a subpoena to an individual, and the SEC's underlying investigation collectively constituted a "claim" that triggered D&O coverage.[36] In this instance the insurer (rather than the insured) had pressed the court to find that the SEC investigation constituted a "claim." The insurer then

27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.* at *6.
31. *Id.* (citing Black's Law Dictionary (10th Ed. 2014)).
32. *Id.*
33. *Id.* at *6.
34. *Id.* at *7.
35. 2017 WL 4233078 (S.D.N.Y. Sept. 22, 2017). An appeal to the U.S. Court of Appeals for the Second Circuit was filed September 27, 2017, and is currently pending.
36. *Id.* at *4.

further took the position that the investigation claim predated the inception of the current policy, so coverage was barred by a "prior or pending claim" exclusion.

The *Patriarch* case involves some key facts about policy renewal that differentiate it from the facts of *MusclePharm*, but otherwise, the chain of events leading to the coverage litigation are similar. The SEC began an investigation into Patriarch in 2009, but the investigation did not begin to pick up steam until the first half of 2011.[37] After an informal review, the SEC issued a formal order of investigation into Patriarch on June 3, 2011.[38] Additionally, the SEC issued a subpoena to Meric Topbas, one of Patriarch's senior executives, on July 1, 2011.[39]

Meanwhile, Patriarch's D&O insurance tower came up for renewal on July 31, 2011.[40] The second excess renewal policy that AXIS Insurance Company sold to Patriarch contained a "prior or pending claim" exclusion endorsement that excluded from coverage all claims '"arising out of or attributable to any demand, suit or other proceeding pending or order, decree, judgment or adjudication entered against any Insured on or prior to July 31, 2011, or any fact, circumstance or situation underlying or alleged therein.'"[41] The policy defined "claim" to include: "a written demand for monetary damages or non-monetary relief (including but not limited to injunctive relief) or a written request to toll or waive the statute of limitations" or an "Investigation of an Insured alleging a Wrongful Act."[42]

Patriarch sought coverage for the SEC investigation from AXIS after the SEC sent Patriarch a subpoena requesting documents in February 2012.[43] The insurers underlying AXIS had accepted the subpoena as a covered claim, but AXIS reserved its rights and then denied coverage based on the prior or pending claim exclusion in its policy.[44] AXIS took the position that the SEC's investigation of Patriarch was a "claim" from the outset, and that the "claim" began before the July 31, 2011, prior and pending date in the policy.[45]

Patriarch then brought a declaratory judgment action against AXIS in the U.S. District Court for the Southern District of New York. Both sides filed cross-motions for summary judgment. Judge Caproni granted AXIS's motion for summary judgment and denied Patriarch's cross-motion. On the cross-motions, Judge Caproni ruled that the SEC's for-

37. *Id.* at *2.
38. *Id.*
39. *Id.*
40. *Id.* at *1.
41. *Id.* at *4.
42. *Id.* at *1.
43. *Id.* at *3.
44. *Id.*
45. *Id.* at *4, *7.

mal order of investigation, its subpoena to Topbas, and its underlying investigation all constituted a "claim" under AXIS's policy.[46] In contrast to the Tenth Circuit in *MusclePharm*, Judge Caproni ruled that the SEC's subpoenas constituted a demand for "non-monetary relief" under the policy's "claim" definition. Judge Caproni reasoned that under Second Circuit precedent, a "demand" is an '"imperative solicitation for that which is legally owed,'" the subpoenas at issue sought documents to be produced, and compliance was not optional.[47]

Notably, just as the Tenth Circuit concluded in *MusclePharm*, Patriarch argued that the SEC's formal order of investigation was not a "claim" because it did not "allege" a "wrongful act" under AXIS's policy. That is, there was no assertion by the SEC that the company or any person had committed fraud or any other illegal activity.[48] However, Judge Caproni rejected the insured's argument, noting that it found a more "commonsense" definition of the term "alleged" to '"necessarily include all acts that *may have been* committed.'"[49] In brushing aside Patriarch's contention that the subpoena did not seek "relief" under the terms of the policy because it did not allege any particular wrongdoing, moreover, the court noted that had both parties wanted to exclude a subpoena from the definition of a "claim" when there was no assertion of civil or criminal liability, they could have done so by limiting coverage to demands for non-monetary relief that allege a "wrongful act."[50] Interestingly, this step was taken by the parties in *MusclePharm*.[51] Thereafter, Judge Caproni concluded that the "claim" came into being before the AXIS policy renewed, and that coverage was barred by the prior and pending exclusion.[52]

B. *Prior Acts Exclusion*

The Eleventh Circuit examined the reach of a prior acts exclusion—akin to a prior or pending claim exclusion—in *Zucker v. U.S. Specialty Insurance Company*,[53] concluding that the term "arising out of" in the exclusion was unambiguous, broad, and defeated coverage under the specific facts before it.[54]

46. *Id.* at *4.
47. *Id.* (citing Gil Enter., Inc. v. Delvy, 79 F.3d 241, 246 (2d Cir. 1996); Minuteman Int'l Inc., v. Great Am. Ins. Co., No 03 C 6067, 2004 WL 603482, at *7 (N.D. Ill. Mar. 22, 2004)).
48. *Id.* at *6.
49. *Id.* (citing Weaver v. Axis Surplus Ins. Co., No. 13-CV-7374 (SJF), 2014 WL 5500667, at *12 (E.D.N.Y. Oct. 30, 2014) (internal citations omitted) (emphasis in original)); *see also id.* at *5.
50. *Id.* at *5.
51. *See* MusclePharm Corp. v. Liberty Ins. Underwriters, 2017 WL 4675701 (10th Cir. Oct. 17, 2017).
52. *Id.*
53. 856 F.3d 1343 (11th Cir. 2017).
54. *Id.* at 1349–50.

The *Zucker* case grew out of the failure of a bank during the 2008 financial crisis and the aftermath of bankruptcy claims asserted against the directors and officers of the bank and its parent company. Notably, as in *Patriarch*, some of the key facts in *Zucker* involve the interpretation and application of policy provisions implemented in renewal and replacement policies purchased after the insured entity already faced problems.

The insured parties in *Zucker* are BankUnited, a federally chartered savings bank, and its parent holding company, BankUnited Financial Corporation (BUFC).[55] Both entities found themselves in severe financial trouble in 2008, and the Treasury Department's Office of Thrift Supervision (OTS) began investigating the bank.[56] Around that time, BUFC's D&O insurer declined to renew its policy.[57] U.S. Specialty Insurance Company offered to provide replacement coverage, even though that it was aware that BUFC was in a precarious financial position and that government regulators were circling.[58]

Given BUFC's tenuous financial footing, U.S. Specialty offered BUFC two policy choices: first, a less costly policy that contained a prior acts exclusion for all conduct occurring before November 10, 2008; or second, a policy without such an exclusion at a much higher premium.[59] BUFC elected to purchase the policy that contained the prior acts exclusion.[60]

Meanwhile, BankUnited and BUFC continued to struggle financially. In May 2009, OTS closed the subsidiary bank and appointed the FDIC as its receiver.[61] BUFC filed for bankruptcy one day later.[62]

BUFC's official committee of unsecured creditors obtained derivative standing to investigate and bring suit against any of the holding company's former directors and officers.[63] A lawsuit was subsequently brought against three of BUFC's former directors and officers, alleging in part that these individuals improperly down-streamed $80 million into the subsidiary bank from BUFC without considering whether the transfer would delay or prevent the bank's closure.[64] The committee also asserted that the decision to approve certain tax refund transfers from BUFC to the subsidiary bank in 2009 was a breach of the fiduciary duty owed to BUFC by its directors

55. *Id.* at 1344.
56. *Id.*
57. *Id.* at 1345.
58. *Id.*
59. *Id.* at 1346.
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.* at 1346–47.
64. *Id.* at 1347.

and officers because the transfers violated Florida's Uniform Fraudulent Transfers Act.[65]

U.S. Specialty denied coverage for the lawsuit against BUFC's former directors and officers.[66] U.S. Specialty asserted that the prior acts exclusion barred coverage because the allegedly fraudulent transfers at issue in the lawsuit resulted from the officers' wrongful conduct that occurred prior to November 10, 2008, as evidenced by the fact that the complaint against the individuals asserted that BUFC's directors and officers engaged in alleged misconduct beginning in January 2007.[67]

BankUnited's plan administrator eventually settled the fraudulent transfer causes of action against the individuals for $15 million, and the former directors assigned their rights under U.S. Specialty's policy to the administrator.[68] The administrator then brought suit against U.S. Specialty, asserting that it wrongfully denied coverage for the settlement.[69] On motions practice, the district court agreed with U.S. Specialty that the prior acts exclusion barred coverage for the fraudulent transfer claims and granted summary judgment to the insurer. The administrator appealed to the Eleventh Circuit.

The Eleventh Circuit affirmed the trial court's conclusion that the prior acts exclusion barred coverage.[70] The prior acts exclusion in U.S. Specialty's policy provided that it would not cover any "'Loss' in connection with a 'Claim' arising out of, based upon or attributable to any 'Wrongful Act' committed or allegedly committed, in whole or in part," before November 10, 2008.[71] The administrator had argued that because the tax refund transfers occurred in 2009 and "insolvency itself is not a wrongful act, those claims should not fall within the prior acts exclusion of the policy."[72] The Eleventh Circuit concluded that even though insolvency is not a "wrongful act," the exclusion applied because the lawsuit against the individuals "arose out of" conduct that predated the U.S. Specialty policy.

Applying Florida law, the Eleventh Circuit noted that the phrase "arising out of" is not ambiguous and is interpreted broadly, meaning "originating from, having its origin in, growing out of, flowing from, incident to, or

---

65. *Id.*
66. *Id.*
67. *Id.*; *see also* Zucker v. U.S. Specialty Ins. Co., No. 1:14-CV-20893-UU, 2015 WL 11216710, at *10 (S.D. Fla. Feb. 12, 2015), *aff'd sub nom.* Zucker for BankUnited Fin. Corp. v. U.S. Specialty Ins. Co., 856 F.3d 1343 (11th Cir. 2017).
68. *Id.*
69. *Id.* at 1347–48.
70. *Id.* at 1351.
71. *Id.* at 1349.
72. *Id.*

having a connection with."[73] In the court's words, "the 'arising out of' standard is not difficult to meet."[74] The court went on to note that the BUFC's bankruptcy clearly arose out of wrongful acts that occurred before November 10, 2008, as amply set forth in the complaint against the former officers.[75] The court noted that while the plan administrator was correct that insolvency is not in and of itself a wrongful act, an "essential element of his claim" was related to prior wrongful acts of the holding company's officers and directors that occurred prior to November 10, 2008.[76]

The Eleventh Circuit also dismissed the administrator's argument that if the prior acts exclusion barred his lawsuit, U.S. Specialty's policy offered only illusory coverage.[77] The court noted that in order for an exclusion to render a policy's coverage illusory, it must eliminate all—or at least virtually all—coverage in the policy.[78] The court took great pains to note that: (1) the policy specifically provided coverage for claims exclusively stemming from conduct after the policy's effective date; and (2) the holding company was a sophisticated consumer and was offered a policy that did not contain a prior acts exclusion.[79] The fact that BUFC elected to obtain an insurance policy with a severe coverage limitation for a much lower premium swayed the Eleventh Circuit's decision.[80] Accordingly, the Eleventh Circuit affirmed the judgment of the lower court.

Of course, many D&O experts are familiar with the "arising out of" language in U.S. Specialty's policy; it is commonly found not only in prior acts exclusions, but also in other exclusions and definitions, such as the definition of "interrelated wrongful acts." The Eleventh Circuit's ruling in *Zucker* will therefore undoubtedly be widely cited by both insurers and insureds seeking judicial support for a broad reading of "arising out of" for the foreseeable future.

III. Architects' and Engineers' Professional Liability

During the past year, courts and legislatures throughout the country have addressed significant issues impacting the liability of architects, engineers, and other design professionals. We discuss below two of the more important issues raised in 2017: developments as to design professionals' con-

73. *Id.* (citing Taurus Holdings, Inc. v. U.S. Fid. & Guar. Co., 913 So. 2d 528, 532 (Fla. 2005) (internal quotations omitted).
74. *Id.* at 1350.
75. *Id.*
76. *Id.* at 1350–51.
77. *Id.* at 1352.
78. *Id.* (citing Interline Brands, Inc. v. Chartis Specialty Ins. Co., 749 F.3d 962, 966–67 (11th Cir. 2014)).
79. *Id.* at 1353.
80. *Id.*

tractual duty to defend and/or indemnify project owners and developers, and the application of the "economic loss doctrine" to preclude claims by third parties whose damages arising from alleged design professional negligence are solely economic in nature.

A. *Duty to Defend and Indemnify Under California Senate Bill 496*

A frequent concern for design professionals retained on construction projects is the breadth of the contractual defense and indemnity obligations they may have to undertake. There is often an imbalance of negotiating power forcing project professionals and sub-contractors to accept very broad defense obligations. Professionals understandably want to secure significant project work and owners and developers have many choices when it comes to the architects, engineers, contractors, and other professionals they retain. An issue of specific concern can be the design professional's agreement to defend an owner, developer, or general contractor for its own negligence.

The California legislature took specific steps this past year to address this concern for construction projects in that state. The California Senate passed, and the governor signed into law, Senate Bill 496, which amended the existing statutory defense and indemnification requirements for design professionals in public works to make them apply to private contracts as well.[81] The amended statute requires that both private and public contracts contain duty to defend provisions that are commensurate with a professional's actual fault, with certain exceptions described below. The bill becomes law as to contracts entered on or after January 1, 2018.

1. Protections of SB 496

SB 496 extends the same protections to design professionals in private contracts entered into on or after January 1, 2018, as apply to public works contracts under California Civil Code Section 2782. Section 2782 curbs the design professional's duties of defending and indemnifying other contract parties for their own negligence. The other significant aspects of the new legislation are described below.

California Civil Code Section 2782, which SB 496 amends, generally provides that contractual obligations to indemnify another party, including the costs of defense, are "unenforceable except to the extent the claims arise out of, pertain to, or relate to the negligence, recklessness or willful misconduct of the design professional."[82] Further, "in no event shall the cost to defend charged to the design professional exceed the design pro-

81. California S.B. 496, ch. 8 (2017), *available at* http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201720180SB496.

82. Cal. Civ. Code § 2782.8(a).

fessional's proportionate percentage of fault." This limitation is not waivable by contract or negotiation of the parties and all contracts, agreements, or solicitation documents for design professional services are deemed to incorporate by reference the terms of Section 2782.8.[83]

There are exceptions, of course. When one or more defendants is unable to pay its share of defense costs due to bankruptcy or dissolution of the business, the design professional is to meet and confer with other parties regarding those unpaid defense costs. "Design professionals" for purposes of the new statute are defined to include licensed architects, landscape architects, registered professional engineers, and licensed professional land surveyors.

Notably, Section 2782 does not apply to contracts for design professional services where (1) a project-specific general liability insurance policy insures all project participants, including all design professionals, on a primary basis; and (2) the contract is a written design-build joint venture agreement. Given the common exclusion of design professionals from wrap insurance policies, it remains to be seen how significant this exception will be on a going forward basis.

2. Prior Rule: *Crawford v. Weather Shield Manufacturing, Inc.*

The California Senate developed SB 496 in an effort to overturn—or at least significantly narrow—*Crawford v. Weather Shield Manufacturing, Inc.*[84] and cases applying it. A review of the *Crawford* case is useful to understand the legal framework that necessitated the passage of SB 496 and to offer insight into how courts and legislatures in other jurisdictions might approach similar issues.

In *Crawford*, a homeowners group brought a construction defect action against the project's developer, JMP, and a window subcontractor, Weather Shield. JMP cross-complained against Weather Shield to recover expenses it incurred defending the suit and indemnification as to JMP's liability to the homeowners. The trial court in *Crawford* concluded that Weather Shield was responsible for JMP's legal defense insofar as the homeowners' claims concerned the windows supplied by Weather Shield, regardless of whether Weather Shield was ultimately found negligent.[85] The court adopted a different approach as to the duty to indemnify, however, and held that the terms of the subcontract obligated Weather Shield to indemnify JMP only if Weather Shield was in fact found negligent.[86]

The California Court of Appeal affirmed. As to the duty to defend, the court held that, regardless of Weather Shield's own negligence, its prom-

83. CAL. CIV. CODE § 2782.8(a).
84. 79 Cal. Rptr. 3d 721 (Cal. 2008).
85. *Id.* at 726.
86. *Id.*

ise to defend JMP against suits arising out of the execution of Weather Shield's work necessarily contemplated a duty that arose at the time such a suit was brought.[87] Because that duty was immediate, it could not depend upon the outcome of issues to be litigated in the very action that Weather Shield was obliged to defend.[88]

The California Supreme Court granted review in *Crawford* limited to the single issue of whether a contract under which a subcontractor agreed "to defend any suit or action" against a developer "founded upon" any claim "growing out of the execution of the work" required the subcontractor to provide a defense to a suit against the developer even if the subcontractor was not negligent. The California Supreme Court concluded that the relevant contract provisions in *Crawford* expressly and unambiguously obligated Weather Shield to defend from the outset any suit against JMP insofar as it was founded upon claims alleging damage or loss arising from Weather Shield's negligent role in the project. Weather Shield therefore had a contractual obligation to defend such a suit even if it were later determined (as actually occurred) that Weather Shield was not negligent.[89] In reaching this conclusion, the court first addressed the public policy framework for non-insurance indemnity agreements. In general, an agreement for a party to be indemnified for its own active negligence or regardless of the indemnitor's fault—protections beyond those afforded by the doctrines of implied or equitable indemnity—requires that the relevant language be clear and explicit; such language will also be construed strictly against the indemnitee.[90] In subsequent cases, the California Court of Appeal concluded that: (1) *Crawford* could apply retroactively,[91] and (2) a contractual assignee could enforce the immediate duty to defend contemplated by *Crawford*.[92] Thus, *Crawford* and its progeny raised two serious concerns for design professionals: (1) the immediacy of the duty to defend, and (2) the breadth of that duty in relation to the indemnitor's actual fault for the problems at issue. These issues prompted California to seek potential legislative solutions, which culminated in the passage of SB 496.

87. *Id.* at 730.
88. *Id.* at 727.
89. *Id.* at 730.
90. *Id.* at 729 (citing, inter alia, E.L. White, Inc. v. City of Huntington Beach, 579 P.2d 505 (Cal. 1978); Rossmoor Sanitation, Inc. v. Pylon, Inc., 532 P.2d 97 (Cal. 1975); Goldman v. Ecco-Phoenix Elec. Corp., 396 P.2d 377 (Cal. 1964)).
91. UDC-Universal Dev., L.P. v. CH2M Hill, 103 Cal. Rptr. 3d 684 (Cal. Ct. App. 2010).
92. Searles Valley Mineral Operations, Inc. v. Ralph M. Parsons Serv. Co., 120 Cal. Rptr. 3d 487 (Cal. Ct. App. 2011).

B. *Economic Loss Doctrine*

Another significant construction litigation issue has been the scope of a design professional's liability to other project parties. Specifically, under what circumstances do other contractors or professionals possess claims arising from an architect's or engineer's act or acts below the standard of care that result in economic losses to the other contractors or professionals? For instance, when design errors significantly delay a project, may other parties seek consequential economic damages for their lost profits or additional project costs?

1. *Balfour Beatty Infrastructure, Inc. v. Rummel Klepper & Kahl, LLP*

In 2017, this issue was comprehensively addressed by the Maryland Court of Appeals in *Balfour Beatty Infrastructure, Inc. v. Rummel Klepper & Kahl, LLP*.[93] In that case, the court concluded that the economic loss doctrine broadly bars a general contractor's professional negligence claim against a design professional on a government construction project.[94] Because this holding has wide implications in the construction law arena, we lay out the facts of the case in detail below.

Petitioner Balfour Beatty was a general contractor that successfully bid for work on a City of Baltimore construction project. It argued that respondent Rummel Klepper & Kahl (RKK), the design engineering firm for the project, owed Balfour Beatty a tort duty of care because RKK knew that Balfour Beatty would rely on RKK's designs in bidding for and then performing the work.

a. City of Baltimore Project—The project in question was a wastewater treatment plant to be constructed for the City of Baltimore. RKK was tasked with designing plans for two interrelated sanitary projects—a primary project and a companion sanitary facility. The design specifications required RKK to, inter alia, develop drawings and specifications for prospective contractors to use when submitting bids and for the successful contractor to use in construction, developing construction timetables for the projects, providing responses to questions from prospective bidders, and evaluating and commenting on the contractors' bids.[95]

Balfour Beatty was the successful bidder for the main sanitation project. It agreed to construct thirty-four denitrification filter (DNF) cells (concrete tubs that hold untreated waste water). Balfour Beatty was also required to construct pipes and pipe support systems for the project. Dur-

93. 155 A.3d 445 (Md. 2017).
94. *Id.* at 449–50.
95. *Id.* at 447–48.

ing construction, Balfour Beatty encountered leaking and other problems that resulted in delays and cost overruns.[96]

b. The Contractor's Lawsuit—Balfour Beatty sued RKK in the Circuit Court for Baltimore seeking to recover its financial losses. It claimed that RKK was required to design the DNF cells using expansion and construction joints that were meant to accommodate changes in water pressure in the cells. However, on completion of the work, testing of the water retention ability of the DNF cells allegedly revealed leaks due to cracks in the expansion joints. Balfour Beatty contended it had constructed the cells according to RKK's design and any leaking from the expansion joints was a direct result of that design.[97]

Balfour Beatty also alleged that RKK had failed to timely complete the design for the companion project, thereby delaying construction of the main project. The suit alleged that RKK had failed to warn prospective bidders of the delayed completion of the companion project's design and that RKK had established an unreasonable timeline for completion of the main project, which Balfour Beatty relied upon in submitting its bid. Balfour Beatty sought recovery from RKK of significant expenses associated with these issues.[98]

The complaint against RKK alleged three causes of action: (1) professional negligence, (2) negligent misrepresentation, and (3) a cause of action based on Restatement (Second) of Torts Section 552.[99] In support of its claims, Balfour Beatty alleged there was an intimate nexus and contractual privity between it and RKK, creating a duty of reasonable care running from RKK to Balfour Beatty.[100] In other words, Balfour Beatty alleged that it was a foreseeable party that would utilize and directly rely upon RKK professional services, including the preliminary and final design of the main project.

RKK moved to dismiss the complaint for failure to state a claim. It argued that in the absence of privity, no legally cognizable tort duty ran from an engineer to a contractor that would permit recovery of purely economic losses. RKK also argued that the intimate nexus test and the Section 552 extra-contractual duty concepts did not apply to design professionals and, even if they did, Balfour Beatty had failed to allege facts satisfying those tests.[101] The trial court granted the motion on the basis of lack of privity.[102]

c. Privity and the Intimate Nexus Test—The Court of Appeals granted certiorari to consider the following questions: (1) does the economic loss

96. *Id.* at 448.
97. *Id.*
98. *Id.* at 448–49.
99. *Id.*
100. *Id.* at 449.
101. *Id.*
102. *Id.*

doctrine bar a general contractor's professional negligence claim against a design professional on a government construction project under the privity-equivalent analysis of the intimate nexus test; (2) does the economic loss doctrine bar a general contractor's action for negligent misrepresentation against a design professional on a government construction project; and (3) does the economic loss doctrine bar a general contractor's action under a Section 552 claim against a design professional on a government construction project? The Court of Appeals answered yes to all three questions and therefore affirmed the judgment of the Court of Special Appeals, which had also affirmed the judgment for lack of privity.[103]

In the Court of Appeals, Balfour Beatty urged that the intimate nexus test—which gauges the closeness of the relationship between the parties—allowed the contractor to pursue RKK.[104] Balfour Beatty further argued that the economic loss doctrine does not apply to professional negligence, Section 552, and negligent misrepresentation claims because the doctrine is limited to products liability cases.[105] RKK responded that the economic loss doctrine did in fact apply and that no recovery was available to Balfour Beatty because it had sustained solely economic losses absent privity.[106] Balfour Beatty's ability to pursue its claims, and the applicability of the economic loss doctrine, thus turned largely on the nature of the relationship between the parties.

The Maryland Court of Appeals previously had recognized that privity is not an absolute prerequisite to the existence of a tort duty; the duty of builders and architects to use due care in the design, inspection, and construction of a building extends to those persons foreseeably subjected to the risk of personal injury because of a latent and unreasonably dangerous condition resulting from that negligence.[107] In *Council of Co-owners Atlantis Condo, Inc. v. Whiting-Turner Contracting Co.*, the Maryland court held that condominium owners could recover the reasonable cost of fixing defective duct work even without privity or actual physical harm.[108] As the court in *Balfour Beatty* stated: "In other words, the prospect of physical injury [can be] sufficient to warrant imposing a tort duty in the absence of privity."[109] In contrast, where there are no safety concerns and the risk is purely economic, the privity requirement does not "erode so quickly or so

103. *Id.* at 449–50.
104. *Id.* at 450.
105. *Id.*
106. *Id.*
107. *See* Council of Co-owners Atlantis Condo, Inc. v. Whiting-Turner Contracting Co., 517 A.2d 336, 338 (Md. 1986), *cited in Balfour Beatty*, 155 A.3d at 452–53.
108. *Id.* at 345.
109. *Balfour Beatty*, 155 A.3d at 453.

far."[110] Instead, in such cases, the courts "have refrained from finding a tort duty absent privity or its equivalent, *i.e*., an intimate nexus."[111]

The intimate nexus test was set forth in *Jacques v. First National Bank of Maryland*.[112] There, the court relied upon two New York Court of Appeals decisions, *Glanzer v. Shepard*[113] and *Ultramares Corporation v. Touche*,[114] to establish the framework for assessing whether an intimate nexus existed between the parties and, consequently, whether a duty of care was owed.[115] In *Glanzer*, an intimate relationship was found between the purchaser of beans and a public bean weigher even though the weigher's contract was with the seller. A significant factor was that the weigher had held itself out as "skilled and careful in its calling."[116] The opposite result was reached in *Ultramares*, where the same New York court declined to impose a duty of care running from accountants to recipients of their audit reports for alleged negligent misrepresentations. There, the court was concerned that a thoughtless slip or blunder could expose accountants to liability at an indeterminate amount for an indeterminate time to an indeterminate class.[117]

In *Jacques*, the Maryland court announced a balancing test by which the privity requirement is relaxed as the magnitude of the risk increases.[118] As a result, the imposition of a duty in favor of a large class of persons is justified where the risk is of death or personal injury. In contrast, where the magnitude of the risk decreases, a closer relationship to the parties must be shown to support a tort duty.[119]

The Maryland Court of Appeals subsequently adopted a three-part test from another New York case, *Credit Alliance Corp. v. Arthur Anderson & Co.*,[120] to assess whether an intimate nexus exists between the parties in the context of accountant liability.[121] The *Credit Alliance/Walpert* test requires the plaintiff to show: (1) the accountants were aware their financial reports were to be used for a particular purpose; (2) a known party was intended to rely on the reports; and (3) there was conduct linking the ac-

110. *Id.*
111. *Id.* (citing Jacques v. First Nat'l Bank of Md., 515 A.2d 756 (Md. 1986); Walpert, Smullian & Blumenthal, PA v. Katz, 762 A.2d 582 (Md. 2000); 100 Inv. Ltd. P'ship v. Columbia Town Ctr. Title Co., 60 A.3d 1 (Md. 2013)).
112. *Jacques*, 515 A.2d at 760–61.
113. 135 N.E. 275 (N.Y. 1922).
114. 174 N.E. 441 (N.Y. 1931).
115. *Jacques*, 515 A.2d at 760–61; *see also Balfour Beatty*, 155 A.3d at 453.
116. *Jacques*, 515 A.2d at 760 (citing *Glanzer*, 135 N.E. at 276).
117. *Ultramares*, 174 N.E. at 444.
118. *Jacques*, 515 A.2d at 760.
119. *Id.*
120. 65 N.Y. 2d 536 (1985).
121. Walpert, Smullian & Blumenthal, PA v. Katz, 762 A.2d 582, 597–602 (Md. 2000).

countants to the party that demonstrates the accountants' understanding of the party's reliance.[122]

The *Balfour Beatty* court observed that regardless of whether the *Credit Alliance/Walpert* test was applied, the privity-equivalent analysis in economic loss cases looks for "linking conduct" that is sufficient to show the defendants knew or should have known of the plaintiff's reliance. As the court also noted, context is therefore "critical."[123]

The Maryland court identified no consensus on whether the economic loss doctrine applies in the construction context.[124] Other jurisdictions are split. The court did find persuasive some other courts' logic of "barring negligence claims for purely economic damages against design professionals in complex construction projects absent privity."[125] The court's view turned, however, on the "unique aspects of large-scale public construction, rather than on the finer distinctions of tort law."[126] At the same time, the court noted that the New York Court of Appeals had extended the *Credit Alliance/Walpert* test to design professionals in the construction industry.[127] The court also noted that imposing a tort duty on design professionals in the context of public projects could likely drive an increase in project costs for government entities.[128]

After considering these competing concerns and split of authority, the Maryland Court of Appeals "decline[d] to extend the privity-equivalent intimate nexus test to design professionals on government construction projects, [but it did] not hold that the test cannot apply to design professionals in other contexts."[129]

The *Balfour Beatty* court also construed the Section 552 claim as a form of negligent misrepresentation.[130] It noted that Section 552 liability depends upon judicial recognition of a tort duty. Because the court had already concluded that the privity-equivalent intimate nexus test did not apply to large scale government construction projects, the complex web of contractual arrangements predominated in injecting a tort duty into the parties' relationship was not in the public interest.[131]

122. *Id.* at 597–98.
123. *Balfour Beatty*, 762 A.2d at 457.
124. *Id.* at 457–61.
125. *Id.* at 459.
126. *Id.* at 460–61.
127. *Id.* at 459–60.
128. *Id.* at 461.
129. *Id.*
130. *Id.*
131. *Id.* at 462.

2. Anticipated Arguments Going Forward

The *Balfour Beatty* opinion illustrates how close an issue the application of the economic loss doctrine can be in a given case. The court left open the possibility that the doctrine might be held not to apply in a future non-governmental project case. The decision also shows how divided the courts are nationally on this issue and that there are many different arguments available to third parties arguing against the doctrine's application in a given case.

IV. LEGAL MALPRACTICE

A. *Failure to Plausibly Allege Harm*

Legal malpractice complaints are not frequently dismissed for failure to state a claim. When they are, it is usually because of a particular legal defect or obstacle, rather than the simple failure of the complaint to recite well-pleaded facts with sufficient "heft" to state a claim. One recent case, *West Bend Mutual Insurance Co. v. Schumacher*,[132] is an exception. In that case, the Seventh Circuit concluded, over a dissent by the third panelist, that an insurance company plaintiff failed to adequately plead causation and damages in a legal malpractice case against the defendant attorneys the insurer had hired to defend a workers' compensation claim asserted against one of their insureds.[133]

The insurer's complaint against the defending attorneys grew out of their alleged failure to follow through on evidence important to the defense of the underlying case. The underlying complainant, who complained of a knee injury, had undergone an independent medical examination by a physician, who provided a written report.[134] This report indicated that the physician's testimony would be favorable to the insurer.[135] The defendants did not speak to or depose the doctor, however.[136] Instead, without seeking the approval of the insurer, the defendant attorneys agreed with complainant's counsel to put a redacted version of the doctor's written report into evidence.[137] The defendant attorneys did not speak to any other witnesses or potential witnesses until the day before the scheduled hearing.[138] Then, they learned that a witness with relevant testimony was out of town and would not be available to testify the following day.[139] They also failed to in-

132. 844 F.3d 670 (7th Cir. 2016)
133. *Id.* at 679.
134. *Id.* at 673.
135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.*

vestigate certain statements made by the complainant bearing on the date he reported his injury.[140]

Prior to the hearing, the attorney defendants disclosed their theory of defense to complainant's counsel.[141] On the day of the hearing, the defendants failed to request a continuance or a bifurcated proceeding to allow for the presentation of additional evidence.[142] Instead, without the insurer's knowledge or agreement, the defending attorneys conceded liability for the workers' compensation claim despite knowing of several facts that tended to undermine the claimant's case.[143]

On appeal, the Seventh Circuit had little difficulty concluding that the insurance company adequately pled duty and that the defendants' various alleged missteps all constituted breaches of the standard of care.[144] The majority, however, ruled that the insurance company failed to recite sufficient factual allegations to establish that the defendant attorneys' missteps caused the insurer any loss in the underlying workers' compensation matter.[145] The majority concluded that the complaint failed to articulate the legal and factual defenses that the insurer lost in the underlying workers' compensation case because of the defendant attorneys' conduct in the underlying matter, or to explain how its final liability would have been any different if the defending attorneys had ably defended the underlying workers' compensation claim instead of executing the stipulation of liability.[146]

The dissent disagreed with the majority's causation analysis and outlined the liability-limiting facts known to the attorney defendants when they conceded liability:

- the claimant completed work on the day of his alleged injury;
- after the alleged injury, the claimant continued to work another two weeks until he was laid off;
- before the alleged workplace knee injury, the claimant's physician had already determined that the claimant needed knee replacement surgery;
- the claimant's own treating physician could not find any change in condition in the claimant's knee after the alleged workplace knee injury; and
- available documents indicated that the claimant did not report the alleged workplace injury when it supposedly happened or even until long after he was laid off and had retained an attorney.[147]

140. *Id.*
141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.* at 677.
145. *Id.* at 677–78.
146. *Id.* at 678–79.
147. *Id.* at 680.

According to the dissent, those facts adequately describe a defense lost as a result of the attorney's conduct: "there was no workplace injury at all, or certainly not one that required surgery that the claimant's own physician had already said he needed before the alleged injury."[148] The dissent observed that judicial experience and common sense suffice to show that the facts establishing the loss of this defense adequately supported the causation and damages elements required to state a claim for malpractice.[149]

B. *Discoverability of Former Client's Communications with Successor Counsel*

Among the most contentious discovery issues in legal malpractice litigation is the discoverability of the plaintiff's communications with successor counsel. Two recent decisions, one by the U.S. District Court for the Southern District of New York and the other by the U.S. District Court for the Northern District of Georgia, reached opposite conclusions on the issue.

1. *Windsor Securities, LLC v. Arent Fox, LLP*

In the first case, *Windsor Securities, LLC v. Arent Fox, LLP*,[150] the Southern District of New York refused to compel the production of the plaintiffs' communications with subsequent counsel. The former counsel seeking the discovery argued that the communications were "at issue" in the malpractice case so that the attorney-client privilege was waived, and that the later communications were relevant to establish whether the strategic decisions the former counsel made caused the plaintiffs' alleged injuries and to substantiate the plaintiffs' claim for attorneys' fees.[151] The facts of the case are discussed in full to give the decision context.

The former attorneys (malpractice defendants) provided Windsor with advice concerning its decision to offer financing to five individuals for the purchase of life insurance and payment of premiums.[152] The attorneys advised Windsor that change of ownership (COO) agreements it obtained from the various trusts holding the insurance policies gave Windsor ownership of and entitlement to the death benefits.[153] When the first insured died, Windsor sought to collect on the death benefit, but the insurers refused to pay.[154] The defendant attorneys represented Windsor in the ensuing arbitration.[155] The arbitrators found that Windsor had not complied with certain policy-transfer requirements under California law and

148. *Id.*
149. *Id.* at 680–81.
150. 2017 WL 3446992 (S.D.N.Y. Aug. 11, 2017).
151. *Id.* at *1.
152. *Id.* at *1–2.
153. *Id.* at *2.
154. *Id.*
155. *Id.*

that, as a result, Windsor was entitled to recover only the premiums it had paid and 10 percent interest.[156] Around this time, Windsor began consulting other counsel and subsequently terminated the attorneys.[157] Unsurprisingly, there was litigation over the death benefits of the other four insureds as well.[158] Ultimately, Windsor recovered less than the full death benefits on all of the policies.[159] Windsor sued the attorneys who advised it with respect to the COOs, claiming that their flawed advice reduced Windsor's recoveries on the life insurance policies and caused it to incur legal fees associated with litigating entitlement to the death benefits.[160]

The attorney defendants moved to compel the discovery of Windsor's communications with successor counsel and the counsel Windsor had consulted during the defendant attorneys' engagement, arguing that the attorney-client privilege was waived because Windsor's malpractice claim put its communications with other counsel "at issue," and that the requested documents would allow the attorneys to determine whether Windsor relied on their legal advice, whether this advice was the proximate cause of Windsor's injuries, and whether the attorney fees Windsor sought to recover were reasonable.[161] The court denied the attorneys' motion to compel.[162] The court rejected the argument that Windsor had waived its attorney-client privilege by placing its communications with successor counsel "at issue."[163] The court held that "at issue" waiver of the attorney-client privilege occurs when "a party affirmatively places the subject matter of its own privileged communication at issue in litigation, so that invasion of the privilege is required to determine the validity of a claim or defense of the party asserting the privilege, and application of the privilege would deprive the adversary of vital information."[164] The court then explained that applicability of "at issue" waiver does not turn on whether the information sought is relevant to the action, but instead depends on whether the party who holds the privilege asserts a claim or defense that it intends to prove by use of the privileged materials.[165]

In rejecting the defendant attorneys' requests for communications with successor counsel, the court further observed that whether the attorneys

156. *Id.*
157. *Id.*
158. *Id.* at *3.
159. *Id.* at *2–3.
160. *Id.* at *3.
161. *Id.*
162. *Id.* at *9.
163. *Id.* at *4.
164. *Id.* at *4 (quoting Deutsche Bank Tr. Co. of Am. v. Tri-Links Inv. Tr., 43 A.D.3d 56, 63 (N.Y. App. Div. 2007) (internal quotation marks omitted)).
165. *Id.* at *5–6.

met the applicable standard of care would be assessed via expert evidence; what the successor counsel thought of the attorney defendants' performance was irrelevant.[166] Nor were the communications required to litigate causation:

> To reduce the problem to simple terms: Windsor is alleging that defendants' actions created a mess that it tried to clean up. Windsor hired new counsel to advise it and assist in cleaning up that mess. Whether Windsor and/or new counsel took appropriate actions to clean up that mess will be judged by the actions Windsor and its counsel actually took, not based on the *advice* its new counsel gave as to how to clean up the mess. Defendants will be free to argue that the method of clean-up was unnecessary or badly performed. But for defendants to make these arguments, it is not necessary for them to learn what was said between Windsor and new counsel.[167]

The court also rejected the claim that the defendant attorneys were entitled to Windsor's communications with attorneys Windsor consulted during the attorney defendants' representation.[168] If Windsor did not follow the attorney defendants' advice, that advice would not be the cause of any loss or injury to Windsor.[169] Whether Windsor failed to follow that advice because it received contrary advice from the other counsel would be irrelevant.[170] If Windsor *did* follow the attorneys' advice, the court reasoned, it would not be a defense to liability to argue that the other counsel furnished the same bad advice, since the defendant attorneys would remain *a* proximate cause of the loss, even if they were not the *sole* proximate cause.[171]

It bears mention that the defendant attorneys did not assert a contribution claim against the other counsel who allegedly advised Windsor during the period of their representation.[172] Perhaps such a contribution claim would have led to a different discovery ruling, although the court signaled skepticism, citing language from a New York case suggesting that piercing the privilege to enable an attorney to assert a third-party claim would "render the privilege illusory," because "the former attorney could, merely by virtue of asserting a third-party claim for contribution against the present attorney, effectively invade the privilege in every case."[173]

166. *Id.* at *7.
167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.* at *9 (quoting Jakobleff v. Cerrato, Sweeney & Cohn, 97 A.D.2d 834, 835 (N.Y. App. Div. 1983)).

Finally, the court rejected the argument that Windsor's communications with the other attorneys were required to assess the reasonableness of the legal fees Windsor was seeking.[174] The reasonableness of these fees was to be evaluated by the fact finder based on the tasks performed and the time spent, not the legal advice provided by counsel.[175]

2. *Monitronics International, Inc. v. Hall, Booth, Smith, P.C.*

The second case, *Monitronics International, Inc. v. Hall, Booth, Smith, P.C.*,[176] takes a more liberal approach to "at issue" waiver and the discoverability of communications with successor counsel. In that case, the Northern District of Georgia compelled discovery of the same kinds of documents and information that were protected from disclosure in *Windsor*: communications with successor counsel and that counsel's case assessments.[177] The *Monitronics* facts follow.

The defendant attorneys had represented Monitronics, a home security monitoring company, in an action brought by a woman who was raped in her home.[178] The defendant attorneys' representation was terminated three months before trial. The case was tried by successor counsel.[179] The jury found Monitronics liable.[180]

In the legal malpractice action that followed Monitronics' unsuccessful trial defense, Monitronics alleged several missteps by the attorney defendants in the course of defending the underlying claim.[181] Most of the alleged errors concerned the failure to adequately investigate the claim and to conduct adequate discovery.[182] Among other things, Monitronics alleged that the attorney defendants failed to pursue evidence that the victim's assailant was not an intruder, but someone connected to her family who had permission to be at her home.[183]

The attorney defendants asserted a number of defenses to the malpractice suit, including lack of causation, and filed a notice seeking to apportion fault to successor counsel.[184] They then sought documents from the litigation files of the successor counsel, including case assessments and documents concerning case strategy.[185] The court permitted discovery and concluded that Monitronics placed its communications with succes-

174. *Id.*
175. *Id.*
176. 2016 WL 7030324 (N.D. Ga. Dec. 2, 2016).
177. *Id.*
178. *Id.* at *2–3.
179. *Id.* at *3.
180. *Id.*
181. *Id.* at *4–5.
182. *Id.*
183. *Id.* at *5.
184. *Id.* at *10.
185. *Id.* at *6–7.

sor counsel "at issue" because such communications were necessary for the attorney defendants to defend the malpractice claim.[186] This interpretation of "at issue" waiver is more liberal than that utilized in *Windsor*, which appeared to limit the waiver to only those documents actually relied on by the legal malpractice plaintiff as evidence. The court in *Monitronics* also differed from *Windsor* in its assessment that the opinions of successor counsel would be relevant to the defense of the legal malpractice claims. For example, the court concluded that if successor counsel chose not to engage in the discovery Monitronics claimed should have been conducted in its malpractice suit, that could tend to discredit the allegation that the failure to conduct that discovery was malpractice.[187] The court observed:

> It would be odd—if not unfair—to preclude Defendants from discovering documents showing whether successor counsel or insurers had views of the evidence and trial presentation that aligned with Defendants'. These kinds of strategy evaluation and litigation decision materials are largely, if not exclusively, the kind of documents maintained in the file of Monitronics and its lawyers and not available to Defendants unless produced.[188]

The contrast between the results and reasoning in *Windsor* and *Monitronics* should serve as a warning for legal malpractice defense counsel that they should not take the applicability of "at issue" waiver for granted, and as a warning to legal malpractice plaintiffs that they should not reflexively assume that attorney-client privilege will shield their communications with successor counsel.

V. Accounting Malpractice

A recurring theme in accounting malpractice cases relates to the role that the plain language and contractual provisions of engagement letters play in determining the scope of the accountant's liability and the terms and conditions under which a putative claimant may bring suit. This year saw cases considering the specific contents of engagement letters in the context of evaluating the viability of third party claims, assessing arbitrability, and determining applicable statutes of limitation. These cases are highlighted below. Also included below is the annual update on accrual of claims and the *in pari delicto*.

186. *Id.* at *10–11.
187. *Id.* at *11.
188. *Id.*

A. *Liability to Third Parties*

While accounting malpractice claims ordinarily involve suits by clients who have privity with their professionals, sometimes third parties attempt to assert claims for malpractice. Privity requirements vary by jurisdiction; for example, Utah's privity rule is statutory. Under Utah's statutory framework, accountants are protected from claims of third-party reliance on accountant work product unless there is (1) fraud or intentional misrepresentation, or (2) a writing by the accountant identifying the third party and the intent by the client that the third party rely on the accounting work product.[189] In most circumstances, therefore, absent fraud, the accounting professional's engagement letter controls third-party reliance.

The Utah Court of Appeals strictly enforced this statutory limitation on liability as against third-party claims this past year in *Reperex Inc. v. Child*.[190] The court hewed to the text of the statutory privity rule, denying a third-party claim because the engagement letter did not specify that a third party would rely on the accountant's work. In ruling, the court rejected arguments that "circumstantial" evidence in the record, including correspondence between the accountant and the third party, would support the conclusion that the conduct of the parties met the "intent of the statute" to allow the claim by the third party.[191] As such, the court's decision in *Reperex* is somewhat striking for judicial restraint: the court concluded, despite the evidence, "our role requires us to apply the text of the statute, not its policy."[192]

B. *Statement on Auditing Standards (SAS) 133*

Going forward, bartering for third-party reliance and memorializing the agreement in writing will become more crucial because July 2017 changes to Statement on Auditing Standards (SAS) 133 go into effect in June 2018. The amended statement on auditing standards will require heightened audit procedures for audited financial statements made in connection with certain securities offerings otherwise exempt from registration under state and federal law, as well as certain non-profits and franchise arrangements. The new SAS 133 presents an opportunity for auditing professionals and legal counsel alike to refine their positions regarding third-party claims as auditors adjust to the enhanced requirements of the new auditing guidance.

C. *Arbitration of Claims Subject to State Law*

Another issue addressed by courts this past year involves the arbitrability of disputes between accounting professionals and their clients. A common

189. UTAH CODE ANN. § 58-26a-602.
190. 392 P.3d 905 (2017).
191. *Id.* at 918 n.6.
192. *Id.*

perception is that arbitration is generally available for accounting malpractice claims because arbitration clauses are popularly included in accountant engagement letters. In reality, however, the arbitrability of a particular dispute is subject to state law and is highly fact dependent. *Lefoldt v. Horne, LLP*[193] is a recent Fifth Circuit decision that highlights this reality. *Lefoldt* turned on a peculiarity of Mississippi law for public engagements. That peculiarity requires contracts and their terms, including arbitration provisions, to be reflected on the minute books of the board or commission of a public entity.[194] This so-called "minutes rule" bars the enforceability of any contract or term not reflected in the minutes of the public entity.[195]

In *Lefoldt*, the accountant's engagement was referenced in the 2009 minutes of a local hospital authority, but the minutes did not contain all of the terms of the engagement letter, including the arbitration clause.[196] The minutes did not reflect at all the accountant's engagement in 2010 and 2012.[197] Because the arbitration clause had not been properly recorded, the question arose whether the parties agreed to arbitrate their claims and whether a court or arbitrator should decide that threshold issue.

The Fifth Circuit concluded that the apparent failure to abide by the minutes rule called into question both whether there was any contract at all (an issue for a court to decide) and whether there was an agreement to arbitrate in the contract (which is presumptively an issue for the arbitrator to decide).[198] The 2010 and 2012 claims were to proceed in court to determine whether a contract even existed with respect to those years.[199] However, the court also held that because the minutes reflected a contract in 2009, an arbitrator must determine whether the claims were arbitrable.[200]

This holding was doubly frustrating for the accountants. They were denied the automatic benefit of the arbitration clause that they purposefully included in their engagement letters, and they were forced to separately litigate different years in different forums. The legal analysis is interesting for its bifurcated approach to separately analyzing contract formation and arbitration clause enforcement. Practically speaking, however, the opinion

193. 853 F.3d 804 (5th Cir. 2017).
194. Wellness, Inc. v. Pearl River Cty. Hosp., 178 So. 3d 1287, 1292–93 (Miss. 2015).
195. *Lefoldt*, 853 F.3d at 813 (noting that "it is the responsibility of the private contracting party to see that the contract was properly recorded on the minutes").
196. *Id.* at 808.
197. *Id.* at 813–14.
198. The leading case on this point is *Rent-A-Center, West, Inc. v. Jackson*, 561 U.S. 63, 70 (2010), which analyzed the difference between whether a contract exists (a judicial question) and whether the parties agreed to arbitrate (a presumptively arbitral question).
199. *Lefoldt*, 853 F.3d at 813–14.
200. *Id.* at 817–18.

underscores the importance of understanding the nuance of local contract law, which could eliminate the benefit of an arbitration provision.

D. *Contractual Limitations Provisions in Engagement Letters*

A growing trend in accounting engagement letters is to impose a contractual statute of limitations to bar claims that are asserted more than a year or two from the date services were last rendered. These time limits have seen some testing this year.

1. *Aaron v. Deloitte Tax LLP*

In *Aaron v. Deloitte Tax LLP*,[201] a New York intermediate appellate court enforced a one-year contractual limit on claims in an estate tax case. The court refused to toll the statute of limitations based on the professional's continuous representation of the client because the limitations period was established by contract rather than statute.[202] Additionally, the engagement letter was expressly limited to work conducted during a seven-month period, further undercutting the claim of continuous representation many years later.[203]

Ultimately, the court deferred to the contractual limitations period because the engagement letter was clear that the estate plan was aggressive and likely to be closely scrutinized by the IRS.[204] The decision makes clear that a sophisticated client who has full knowledge of the risks associated with aggressive tax planning can waive its right to allege malpractice regarding the risks taken due to the passage of time because (for obvious reasons) an estate plan can be untested by taxing authority for decades.

2. *EPIC v. CliftonLarsonAllen LLP*

The Washington Court of Appeals also permitted auditors to contractually limit the time for clients to bring claims in *EPIC v. CliftonLarsonAllen LLP*.[205] In *EPIC*, the court upheld a limit that was two years from the date of the last audit report and that also granted a year to bring suit after notice of the claim. Despite this ruling, it is not clear that the private two-year limit is actually a bright-line rule in Washington because of two important limits on the ability to enforce a negotiated limitations period: (1) Washington courts will not enforce a contractual limit that expires before the claim to be asserted accrues, and (2) Washington courts will not enforce a limit that requires a suit to be filed before a putative plaintiff

201. 50 N.Y.S.3d 279 (N.Y. App. Div. 2017).
202. *Id.* at 280.
203. *Id.*
204. *Id.*
205. 199 Wn. App. 257 (Wash. Ct. App. 2017).

has an ascertainable loss.[206] It seems that the measure of reasonableness, at least in Washington, is the gap between discovery of a claim and the contractual limitations period, rather than the absolute length of the contractual limitations period. *EPIC* holds that a one-year gap between discovery and the expiration of the statutory period is sufficiently long to consider and bring a claim.[207]

E. *Accrual of Claims for Statute of Limitations Purposes*

1. *EPIC*

A question that often goes hand in hand with the limitations period is ascertaining when the claim accrues and the limitations period begins to run. The Washington court considered this issue in *EPIC*, as well. The court held, in the context of the audit malpractice claim at issue, that "a cause of action accrues when the plaintiff discovers, or in the reasonable exercise of diligence should discovery, the salient facts underlying the cause of action's elements."[208] The court clarified that the necessary "discovery" is the discovery of the "factual basis, not the legal basis, for the cause of action."[209] Furthermore, the court made clear that in the context of a breach-of-duty case, as in *EPIC*, "the running of the statute of limitations does not toll until a plaintiff consults an expert or until an attorney tells the plaintiff that a defendant breached the applicable standard of care."[210] At the same time, however, the court rejected the argument that the plaintiff must know or appreciate the full extent of the harm: "[A] cause of action accrues when the plaintiff knows or should know of some damage. When a plaintiff is placed on notice by some appreciable harm occasioned by another's wrongful conduct, the plaintiff must make further diligent inquiry to ascertain the scope of the actual harm."[211]

2. *Coulter v. Grant Thornton, LLP*

The Arizona Supreme Court reached a similar conclusion about the accrual of accounting malpractice claims this year in *Coulter v. Grant Thornton, LLP*.[212] There, the court held that the two-year statute of limitations for tax accounting malpractice begins to run "when the plaintiff knew or should have known of the negligence and resulting injury under the facts of the particular case."[213] In reaching this holding, the court rejected two

206. *Id.* at 271–72.
207. *Id.* at 277.
208. *Id.* at 274.
209. *Id.* at 276.
210. *Id.* at 275.
211. *Id.* at 276.
212. 241 Ariz. 440 (2017).
213. *Id.* at 445.

other bright-line accrual rules: (1) that the statute begins to run when the IRS issues a notice of deficiency, and (2) that the statute begins to run when the "taxpayer's liability is ultimately resolved."[214] Notably, although not at issue in *Coulter*, a third bright-line rule exists in jurisdictions like Georgia, where statutes of limitation for professional negligence run from the alleged breach of duty by the defendant rather than the discovery of the harm by the plaintiffs.[215] These supposedly "bright line" versions of accrual rules are variations on a theme: each is an effort to start the statute of limitations on discovery of the cause of action, but each bright-line rule suffers when applied to circumstances different from those anticipated at the rule's creation. For example, in *Coulter* the court discussed timing the accrual from the final disposition of a claim by the IRS (one of the bright-line rules) but noted that if "an accountant . . . has acknowledged that the challenged advice was improper, or if the taxpayer obtained a second opinion advising that the advice was improper, a fact-finder could conclude that the taxpayer was on notice of a viable accounting malpractice claim before a final tax court determination."[216]

F. In Pari Delicto

It would not be an annual update without a new entry in the *in pari delicto* case law files. *In pari delicto* means "of equal fault" and is a legal doctrine that bars claims by ne'er-do-wells seeking to assert claims against professionals for malpractice, generally for not stopping the ne'er-do-well plaintiff from lying, cheating, and stealing. The most active areas for the courts involve imputation, i.e., whether a successor-in-interest will be imputed with the bad acts of a former principal or entity. Decisions on this issue went both ways this year. In *Nicholson v. Shapiro & Associates, LLC*,[217] an Illinois appellate court held that, as a matter of Illinois state law, an SEC receiver will not be imputed with the bad acts of the company in receivership.[218] On the other hand, in *Kapila v. Grant Thornton, LLP*,[219] a federal court in Florida held that the bad acts would be imputed on a state-law bankruptcy trustee because under Florida law a company is "barred from shifting the responsibility for its own fraud to its auditors."[220] On reconsideration, the court conceded that "[w]here a trustee or receiver of a corporation is the plaintiff rather than the corporation itself, the application of the in pari delicto doctrine becomes more compli-

214. *Id.*
215. *See, e.g.*, Bryant v. Golden, 302 Ga. App. 760, 761–62 (Ga. Ct. App. 2010).
216. *Coulter*, 241 Ariz. at 445.
217. 82 N.E.3d 529 (Ill. App. Ct. 2017).
218. *Id.* at 533.
219. 2017 WL 2590975 (S.D. Fla. Mar. 9, 2017).
220. *Id.* at *4.

cated."[221] Nonetheless, the court concluded that the particular facts in question offered no reason to depart from its prior decision that an *in pari delicto* defense could be asserted against a bankruptcy trustee.[222] These cases illustrate the point that this law is not settled and that imputation remains dependent on the facts of the case and the jurisdiction.

VI. INSURANCE AGENTS' AND BROKERS' LIABILITY

The prior year saw a number of interesting developments in regards to insurance agent and broker errors and omissions (E&O) cases, including cases examining: when a "special relationship" or "special circumstances" exist sufficient to give rise to a duty to advise; the applicability of the "duty to read" in the context of statute of limitations accrual analysis and as a basis for a contributory negligence defense; when a negligent misrepresentation claim can properly be stated in the context of a broker failure to advise a claim; and how the courts will analyze proximate causation of defenses. Recent cases addressing these topics are discussed below.

A. *Special Relationship*

1. *BioChemics, Inc. v. Axis Reinsurance Co.*

In *BioChemics, Inc. v. Axis Reinsurance Co.*,[223] a Massachusetts federal court declined to find a special relationship between a broker and insurance client that would impose a fiduciary duty on the broker to procure policies that best suited the client's insurance needs. The case arose after the broker, Brown & Brown, notified its insurance client BioChemics, Inc., a specialty pharmaceutical company, that its then current D&O carrier (XL) would be restricting D&O coverage in the coming policy year and increasing premiums.[224] Thus, the broker recommended that BioChemics purchase D&O coverage from a different insurer (Axis) at the conclusion of the XL policy term.[225] As part of the process of applying for the replacement coverage, which was to be offered on a claims made and reported basis, BioChemics was asked to confirm that all known claims had been noticed to XL, and it did so.[226] In reality, BioChemics had not provided notice to XL that BioChemics had been the subject of a Non-Public Formal Investigation by the SEC commencing six months earlier by Formal Order, which included the SEC serving a series of document subpoenas.[227] BioChemics sought insur-

221. Kapila v. Grant Thornton, 2017 WL 3638199 (S.D. Fla. Aug. 23, 2017).
222. *Id.* at *2.
223. 2017 WL 4317384 (D. Mass. Sept. 28, 2017). An appeal to the U.S. Court of Appeals for the First Circuit was filed October 31, 2017, and is currently pending.
224. *Id.* at *1.
225. *Id.*
226. *Id.* at *2.
227. *Id.*

ance coverage for the cost of responding to the SEC subpoenas from its replacement D&O insurer AXIS.[228] The subpoenas revealed the existence of the Formal Order filed against BioChemics during the preceding D&O policy period; in fact, BioChemics had retained counsel to represent it in regards to the SEC investigation.[229] AXIS denied coverage on the theory that the SEC investigation, if it could be covered at all, was a claim first made in the prior policy period.[230] In the insurance coverage litigation that followed, the court summarily found in favor of AXIS.[231]

After failing in its bid to obtain D&O coverage for the SEC investigation, BioChemics sought alternative relief against its broker, Brown & Brown, for alleged negligence and breach of fiduciary duty. BioChemics alleged that Brown & Brown had been negligent in failing to advise it on the risks associated with the expiration of the XL policy.[232] In this regard, the chief executive officer claimed that he did not understand that the SEC investigation amounted to a reportable D&O claim, and if Brown & Brown had properly advised him prior to the expiration of the XL policy, he would have preserved BioChemics' coverage thereunder by reporting the investigation.[233] He further alleged that he would have "perceived the coverage significance" of the SEC investigation if the broker had asked questions about potential claims at the time of the policy renewal.[234]

The broker moved for summary judgment on the grounds it owed no duty to advise, and the court granted the motion. In reaching this decision, the court noted that under Massachusetts law, brokers generally do not owe a fiduciary duty of care to their customers to ensure that the insurance policies procured on their behalf are adequate for their needs, absent "special circumstances of assertion, representation and reliance."[235] BioChemics argued that the requisite special relationship existed by virtue of its long-term relationship with a business and insurance consultant who had introduced BioChemics to Brown & Brown's corporate predecessor and further argued that Brown & Brown had inherited this relationship.[236] But BioChemics was unable to present any evidence of representations made by the consultant on which it had relied.[237] Further, while Brown & Brown worked annually with BioChemics to obtain competitively priced coverage, BioChemics' president and CEO could not recall ever seeking specific advice

228. *Id.*
229. *Id.*
230. *Id.*
231. *Id.*
232. *Id.* at *3.
233. *Id.*
234. *Id.*
235. *Id.*
236. *Id.* at *4.
237. *Id.*

from anyone at Brown & Brown with respect to insurance coverage issues, nor could he recall anyone else at BioChemics having done so.[238] Instead, he testified to just having "a general expectation that [the broker] would provide adequate coverage."[239]

The Massachusetts court found that there were no special circumstances giving rise to a fiduciary duty of care.[240] Accordingly, the court found that Brown & Brown was entitled to accept BioChemics' representation that it had reported all known D&O claims to XL and was "under no duty to ferret out potential claims left unreported."[241]

2. *Certain Interested Underwriters at Lloyd's London v. Bear, LLC*

A California federal court reached a different result on the "special relationship" issue in *Certain Interested Underwriters at Lloyd's London v. Bear, LLC*,[242] concluding that the insurance client had alleged sufficient facts about the owner's long-term relationship with the broker, and the client's reliance on the broker's expertise in making its insurance-purchasing decisions, to create an issue of fact as to whether a special relationship existed.[243] The case came about after a yacht valued at $17 million sustained damage to its hull and was destroyed by fire during the course of repair work at a shipyard.[244] The specific cause of the fire was "hot work repairs" to the hull.[245] The yacht was insured for damages caused during repair work, but the policy had a "Maintenance and Repair Clause" that barred coverage for any hot work, other than soldering, unless the insured provided the underwriters in advance the full details and schedule of the work, a copy of the shipyard's Ship Repairers Liability Insurance, and obtained the underwriters written agreement to the work.[246] Additionally, the policy provided that the insured could not agree to waive subrogation without the underwriters' written agreement.[247] The insured, rather than follow these requirements, had both signed an agreement containing a waiver of subrogation and had allowed the yacht to undergo repairs involving hot work without first obtaining the underwriters' written agreement.[248]

The underwriters commenced an action against the owners of the destroyed yacht seeking a declaration that they had no duty to indemnify the

238. *Id.*
239. *Id.*
240. *Id.*
241. *Id.*
242. 260 F. Supp. 3d 1271 (S.D. Cal. 2017).
243. *Id.* at 1281.
244. *Id.* at 1276.
245. *Id.*
246. *Id.* at 1275.
247. *Id.*
248. *Id.* at 1276.

owner for the loss. The owner counterclaimed for coverage from the underwriters and also brought a third-party action against its broker, Marsh, for breach of contract in failing to procure the requested coverage, breach of fiduciary duty in failing to inform and explain the coverage to the owner, negligence in its procurement of the requested coverage, and negligent failure to advise.[249]

Following discovery, Marsh moved for summary judgment dismissing each of the claims that the yacht owner asserted against it, based on the following facts:

- There was no dispute that Marsh had procured a policy for the requested limits that would have provided $17.25 million in coverage but for the owner's failure to comply with the policy's conditions precedent with respect to coverage for the repair work;[250] and
- Both in its initial proposal and during each renewal of the policy, Marsh had repeatedly warned the owner "to keep in mind the warranties and exclusions of the policy, especially those related to liabilities assumed under contract which are excluded unless approved by underwriters beforehand," and specifically warned about the "Maintenance and Repair Clause."[251]

The court accepted Marsh's arguments in part and dismissed several of the yacht owner's claims. But the court denied Marsh's bid to throw out the negligent failure to advise claim. In doing so, the court noted that there is generally no duty to advise absent a "special relationship." In this instance, however, the court found that sufficient facts had been alleged to create an issue of fact as to whether there was a special relationship based on the owner's long-term relationship with Marsh and its reliance on Marsh's expertise in making its purchasing decisions.[252] Further, the court found that if a special relationship could be established, a jury could potentially find that Marsh had been negligent in failing to advise the owner not to agree to a policy with the Maintenance and Repair Clause in question for a vessel with a steel hull.[253]

Interestingly, Marsh argued that the negligent failure to advise claim should be dismissed in any event because, even though the owner had identified a Chubb policy that would have provided coverage without imposing the same advance notice of repair work, the owner could not establish that (1) it would have chosen the Chubb policy instead of the Lloyd's policy had Marsh recommended it, despite the owner's concerns about pricing; (2) Chubb would have renewed on the same terms every year and the owner would have elected it every year; and (3) Chubb would

249. *Id.*
250. *Id.* at 1277–78.
251. *Id.* at 1279–80.
252. *Id.* at 1281.
253. *Id.*

have covered the loss despite the owner's failure to notify of the work in advance.[254] The court recognized the significance of these causation issues, but concluded that the owner had created an issue of fact as to each by submitting a declaration from the boat's captain stating that his prior experience with a fire during welding performed while the boat was being built would have led him to choose the Chubb coverage had it been offered; and via the testimony of an expert that it was "highly probable" that Chubb would have continued to offer the same policy, the owner would have continued to renew it, and it would have covered the loss.[255]

3. *Rick Friedman Enterprises, Ltd. v. Travelers Indemnity Co.*

In contrast to the yacht case, in *Rick Friedman Enterprises, Ltd. v. Travelers Indemnity Co.*,[256] a New York state court dismissed a claim for alleged negligent failure to advise despite facts that might appear to give rise to a special relationship between the parties. The insurance client alleged that its broker had been its agent for ten years and had marketed itself as having a commitment to service and having the ability to obtain business and flood insurance.[257] The court concluded that these facts were "insufficient to demonstrate anything beyond a longstanding business relationship."[258]

4. *FDT Group, LLC v. Guaraci*

An Ohio appellate court likewise concluded that no special relationship existed between an insurance client and broker on the facts before it in *FDT Group, LLC v. Guaraci*.[259] In that case, a business location owned by the plaintiff with the lower of two floors partially below grade suffered floor damage due to a water pipe backup, and there was no coverage for the claim because the business property policy did not include water backup coverage.[260] The business owner sued the broker who placed the coverage, contending the broker owed a fiduciary duty to recommend water backup coverage after touring the properties and seeing that they were partially below grade.[261] After discovery was taken, the broker moved to dismiss on summary judgment and the motion was granted. On appeal, the ruling was sustained.

The appellate court concluded that the parties shared an "ordinary" broker-insured relationship "and that no special relationship of trust

254. *Id.*
255. *Id.*
256. 2017 WL 119766 (N.Y. Sup. Ct. Jan. 9, 2017).
257. *Id.* at *1.
258. *Id.* at *3.
259. 2017 WL 712793 (Ohio Ct. App. Feb. 23, 2017).
260. *Id.* at *3.
261. *Id.* at *2.

and confidence existed between the parties."[262] In reaching this decision, the court found that the plaintiff had only used this broker for about a year, regularly used a competitive bidding process to solicit proposals, did not have a personal relationship with and did not communicate with the broker directly, admitted that he was the ultimate decision maker regarding insurance for his business, knew about water backup coverage generally and had it on other properties, and knew it was his responsibility generally to make sure the coverage he wanted was included within the policies purchased.[263]

B. *Accrual of Claims for Statute of Limitations Purposes*

One of the arguments that brokers defending against negligent failure to procure claims have tried to make, with only limited success in recent years, has been that the claim should accrue for statute of limitations purposes on the date the insured client received its policy, as opposed to the date when the client discovered that the policy did not provide the requested coverage (i.e., the date coverage for a claim was challenged, questioned, or denied). This argument turns on the theory that because an insured has a duty to read his/her policy, if the lack of coverage is clear on the face of the policy, then the claim should accrue upon receipt of the policy.

1. *American Family Mutual Insurance Co. v. Krop*

This year, the Illinois Appellate Court rejected in *American Family Mutual Insurance Co. v. Krop*[264] the previously established rule that a negligent failure-to-procure claim accrued on the date the insureds received their policy and tolled the statute of limitations until the date the insureds first learned the policy would not cover their claims.[265] *Krop* thus overturned a case that had been in place since 2012.[266] To give this ruling context, the Illinois court in *Krop* reversed dismissal of a claim brought more than two years after a homeowner's' policy had been issued, but within two years of the homeowners learning that the policy would not provide the requested coverage for a claim being made against their son. As the rationale for its decision overruling the prior decision, the court held that an insurance agent/broker owes a fiduciary duty to his insured under Illinois law. Because a fiduciary duty is owed, this implicates the tolling of the statute of limitations until the breach of the agent/broker's duty of care has been discovered.[267]

262. *Id.* at *5.
263. *Id.*
264. *See* 82 N.E.3d 533 (Ill. App. Ct. 2017).
265. *Id.* at 541–42.
266. *See* Hoover v. Country Mutual Ins. Co., 975 N.E.2d 638 (Ill. App. Ct. 2012).
267. *Krop*, 82 N.E.3d at 541–42.

2. *RVP, LLC v. Advantage Insurance Services, LLC*

Another Illinois appellate court issued a decision more favorable to brokers on the statute of limitations accrual date when a reduction in coverage was evident from the face of an insurance policy. In *RVP, LLC v. Advantage Insurance Services, LLC*,[268] after insurance coverage for a recycling business's equipment, stock, and inventory was canceled, and separate insurance for its sister company's buildings was non-renewed, the insurance broker was instructed to find the same or similar coverage elsewhere.[269] The broker obtained replacement insurance for the equipment, stock, and inventory for $925,000 less than had been in place.[270] The broker also procured property coverage with $1 million less in limits than had been in place before and that provided lesser overall blanket limits.[271] As a result, when a fire occurred causing substantial damage to the recycling company's buildings and their contents, it received a property recovery for almost $1,500,000 less than would have been available on one of the buildings under prior insurance, and less coverage than the company believed would have been recoverable for the lost business equipment and contents.[272] The company brought suit against the broker within two years of the fire loss, but more than two years after the replacement coverages were bound.[273]

The broker obtained summary judgment on the basis that the claims were barred by the two-year statute of limitations in effect under Illinois law for all causes of action by an insured against his insurance producer concerning the sale, placement, procurement, renewal, cancellation of, or failure to procure insurance under Section 13-214.4 of the Illinois Code of Civil Procedure.[274] The plaintiffs had opposed on the grounds that the statute of limitations should not be deemed to have accrued until after the loss when it was first learned that the replacement policies would not provide the same coverage as the prior policies.[275] As support for this argument, the CFO admitted signing applications for the policies, but argued that he had not seen the completed applications and simply signed the last page of each.[276]

The court found in favor of the broker because the policies clearly indicated the reduced limits on their face and had been received more than

268. 82 N.E.3d 619 (Ill. App. Ct. 2017).
269. *Id.* at 621.
270. *Id.*
271. *Id.*
272. *Id.* at 622.
273. *Id.* at 624.
274. *Id.* at 623.
275. *Id.* at 624.
276. *Id.* at 621.

two years prior to the commencement of the lawsuit.[277] As such, the court rejected plaintiffs' argument the claims did not accrue until after the plaintiffs were made aware of the limited coverage available. While the court expressly did not address whether failure to read the policy would present an absolute bar to plaintiffs' claims generally, in this case because the policy limits were each clearly stated in the policy declarations pages, upon receipt plaintiffs should have known the policy limits failed to match what had been requested.[278]

3. *Catlin Specialty Insurance Co. v. Tegol, Inc.*

In one other decision of note, a North Carolina federal court anticipated how North Carolina's Supreme Court would rule in *Catlin Specialty Insurance Co. v. Tegol, Inc.*[279] The court concluded that the statute of limitations for a claim of breach of fiduciary duty by a broker would accrue when the insured discovered or ought to have discovered, through reasonable diligence, that its insurance policies did not include the trademark infringement coverage the plaintiff allegedly had been relying on the agent to procure.[280]

C. *Insured's Duty to Read His/Her Policy*

In most jurisdictions, it is recognized that an insured has a duty to read his policy. To the extent the insured fails to do so, and thus is unaware the coverage purchased does not match what the broker was asked to procure, the broker can argue the insured should be found responsible, at least in part, for the insured's comparative negligence. While there was a time when this could provide a complete defense to broker liability in a significant number of jurisdictions, the prevailing rule is now that the insured's failure to read his policy can provide the basis only for a comparative fault finding.

1. *Brown v. State Farm Fire & Casualty Co.*

A small number of states still hold that an insured's failure to read the policy remains a complete defense to a broker's negligent failure to procure claim. One of those states is Alabama, which reaffirmed its minority approach in a federal court decision early in the year. In *Brown v. State Farm Fire & Casualty Co.*,[281] an Alabama federal court dismissed a claim against a broker due to the insured's failure to read his insurance policy.[282] The court found conclusive that the insured conceded the policy was in full force and effect at all times

277. *Id.* at 624.
278. *Id.* at 625–26.
279. 2017 WL 252290 (W.D.N.C. Jan. 19, 2017).
280. *Id.* at *9.
281. 2017 WL 492992 (N.D. Ala. Feb. 7, 2017).
282. *Id.* at *6.

relevant to the claims, so he had—but breached—his duty to read the policy.[283] The plaintiff in *Brown* was a homeowner who had suffered property damage resulting from a lightning strike to his home, and his insurer had denied coverage.[284] The homeowner sued both the insurer (State Farm) and his broker in state court, and State Farm removed the case to federal court. The homeowner sought remand based on his joint residency with the broker in Alabama.[285] However, the federal district court denied remand, holding that the homeowner could not pursue a negligent procurement claim against the broker because the homeowner's failure to read his policy made him contributorily negligent.[286]

In short, under Alabama law, an insured's failure to read his or her policy constitutes contributory negligence and remains a complete defense to a negligent failure to procure claim.[287] Additionally, under Alabama law, the homeowner's acceptance of the policy without objection vitiated any claim he might otherwise have had for breach of contract.[288]

2. *Holmes v. Sheppard*

The contributory negligence of the insured in failing to read his policy can also result in dismissal of a broker negligence claim in its entirety in North Carolina. However, a North Carolina appellate court decision issued in the latter part of last year pointed out some limitations in the use of the failure to read as a complete defense in that state. In *Holmes v. Sheppard*,[289] the plaintiff owned a number of residential and office buildings. A water damage claim to one of the buildings was denied because it had been vacant for more than sixty consecutive days immediately prior to the loss.[290] After the denial, the building owner sued his broker, asserting claims for negligent failure to procure coverage that would insure the building, even if vacant, and negligent misrepresentation.[291] A key point of contention was the expectation and understanding of the building owner. He claimed that he specifically requested coverage that would apply even if the building was vacant.[292] In contrast, the broker claimed this was not the case and, in fact, that the building owner had advised that the building would be leased or rented within thirty days.[293]

283. *Id.* at *7.
284. *Id.* at *2.
285. *Id.* at *4.
286. *Id.* at *7.
287. *Id.* at *6–7.
288. *Id.* at *7
289. 805 S.E.2d 371 (N.C. Ct. App. 2017).
290. *Id.* at 373.
291. *Id.*
292. *Id.* at 375.
293. *Id.* at 373.

The broker moved for and was granted summary judgment based on the fact that the building owner had received the policy without objection and admitted he had not read it.[294] On appeal, the appellate court reversed the dismissal of the negligent failure-to-procure claim. In so doing, the court found significant that the building owner had testified to having specifically requested a policy without a vacancy exclusion.[295] Assuming the trier of the fact were to accept the plaintiff's version of events, this would create a duty on the part of the broker to purchase such coverage.[296] While North Carolina law provides that contributory negligence in failing to read a contract can result in knowledge of the contents being imputed to him, and dismissal of the negligence claim, the court pointed out that this rule applied only to the extent "nothing has been said or done to mislead [the plaintiff] or to put a man of reasonable business prudence off his guard."[297] Because there were facts in evidence to suggest the plaintiff may have been misled or "put off his guard" by the broker advising that the coverage had to be placed with a different insurer to address the vacancy issue, the court concluded that the plaintiff's admitted "failure to read the policy [did] not necessitate as a matter of law that summary judgment be granted on his claim that Defendants were negligent."[298] The court also rejected the argument that the plaintiff's receipt of the policy without objection essentially effected a novation, and agreement to accept the policy actually procured in place of the policy requested.[299]

Significantly, although the court allowed the negligent procurement claim to proceed, it dismissed the insured's negligent misrepresentation claim against the broker. In so doing, the appellate court noted that there was no evidence that the alleged false information provided by the broker could not have been discovered to have been untrue by the exercise of reasonable diligence—i.e., the insured reading the policy.[300]

D. *Negligent Misrepresentation of Policy Coverage*

This year also saw case law address the duties that insurance companies owe to brokers to correctly represent the scope of coverage their policies provide. In *Loomcraft Textile & Supply Co. v. Schwartz Brothers Insurance Agency, Inc.*,[301] an Illinois appellate court limited the liability that an insurance company owes to a broker when the insurer allegedly misrepre-

294. *Id.* at 375.
295. *Id.* at 376.
296. *Id.* at 375–76.
297. *Id.* at 375.
298. *Id.* at 376.
299. *Id.* at 377.
300. *Id.*
301. 2017 WL 1242780 (Ill. Ct. App. Apr. 3, 2017).

sents the coverage that its policy will include. In *Loomcraft*, a company engaged in the business of supplying commercial fabric and finished goods (Loomcraft) retained a broker (Schwartz) to purchase commercial general liability coverage to replace its coverage with Liberty Mutual.[302] The Liberty Mutual policy contained a "selling price endorsement" that insured against any loss or damage to finished goods or merchandise that Loomcraft held for resale.[303] The endorsement set the coverage value at the regular cash selling price, minus certain discounts and charges.[304] Fireman's Fund issued the replacement policy. The broker allegedly received representations from a Fireman's Fund underwriter that the Fireman's Fund replacement policy provided the same finished goods coverage as the Liberty Mutual policy, and that no separate endorsement would be required.[305] In fact, the Fireman's Fund coverage only applied to products manufactured by Loomcraft and did not apply to products which Loomcraft finished and held for sale to others.[306] As a result, when Loomcraft suffered a loss it valued at $608,611.85, it was reimbursed only for limited replacement costs, and thus sustained $529,980.58 in uninsured loss. The broker Schwartz conceded that it had confirmed to Loomcraft that the Fireman's Fund coverage contained the same selling price endorsement as the Liberty Mutual policy, and the court granted summary judgment in Loomcraft's favor against Schwartz.[307]

After settling with Loomcraft, the broker Schwartz pursued third-party claims against Fireman's Fund for indemnification pursuant to the terms of its agency agreement with Fireman's Fund. The agency agreement made Fireman's Fund responsible for the broker's losses arising out of the insurance company's errors:

> [Fireman's Fund] will indemnify you and hold you harmless, including paying your reasonable defense costs, against liability for damages, fines and penalties, arising out of acts we took or failed to take, and for our errors and omissions, and for your acts taken at our direction.[308]

Despite this seemingly straightforward indemnification agreement, the trial court dismissed Schwartz's indemnification claim on summary judgment, and the appellate court affirmed. The appellate court concluded Schwartz had failed to establish a right to indemnification based on either negligent misrepresentation or professional negligence. First, with regard to the negligent misrepresentation claim, the court held "[f]or a claim of

302. *Id.* at *1.
303. *Id.*
304. *Id.*
305. *Id.* at *2.
306. *Id.*
307. *Id.*
308. *Id.*

negligent misrepresentation, the defendant has to be in the business of supplying information to guide others, in contrast to information that is supplied as ancillary to or in connection with the sale of merchandise or other matter."[309] Accordingly, because Fireman's Fund is in the business of selling insurance rather than supplying information, and the information it supplied is ancillary to the sale of insurance, a claim for indemnification based on negligent misrepresentation could not be made.[310] Second, with respect to the professional negligence claim, the court found Schwartz failed to support his claim with the expert testimony needed to establish the standard of care that the insurance company owed to its brokers and agents.[311] Because "there is no defined 'duty of care' or 'standard of care' regarding an insurer's representations about coverage to the broker/producer, and whether the insurer can expect that a broker/producer would rely solely on such representations without examining the policy itself," a standard of care expert was necessary.[312] Schwartz's failure to offer such expert testimony subjected the claim to dismissal on summary judgment.

309. *Id.* at *4.
310. *Id.* at *5.
311. *Id.* at *6.
312. *Id.*