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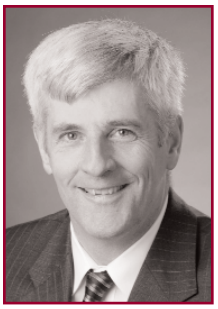
PROFESSIONAL LIABILITY 101

by Patrick W. Brennan



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First, how is a professional service defined? It is usually thought that a professional service is predominantly intellectual and varied in character as opposed to work that is routine, ministerial or physical. Discretion, judgment, and non-standard output are attributes. A higher level of education is one hallmark of the professional. Industry codes of ethics and government licensure are common. The promise to render services for a fee, subject to agreed terms and conditions, is the essence of the professional's undertaking.

A distinguishing feature of the professional liability claim is the source of the duty owed: whether government regulation, industry ethical standards, or company code of conduct, a variety of directives inform and give shape to the professional's duty of care. All combine to create an elevated standard of care, or at least one that is commensurate with the training and expertise of a person who provides higher level services for a fee.

Typically professional services do not entail the sale of goods, but the line may not be clear.[1] How have the courts ruled? Auctioneers are not.[2] Insurance intermediaries may be depending on the state.[3] Professional liability consideration has historically focused on doctors, lawyers, accountants and engineers. While these classes remain the usual focus, the concept of 'who is a professional' has broadened lately, as have the categories of occupations to which professional liability standards are now applied. Public outcry over various corporate scandals and ensuing legislation has created a need for vigilance on modern levels of exposure. Whether individual or corporate, risk of reputation loss is of paramount concern in a professional liability case.[4] Whether certain jobs are deemed 'professional' makes a big difference, so this article will explore the meaning of the term and the ramifications of holding occupations liable under a 'professional' standard of care.

CONTRACT FORMATION

Before embarking on a project, a professional should commit to writing not only the price, goals, and objectives of the job, but also some basic risk management concepts. A good contract is an essential prerequisite not only to proper performance of the work, but to accurately prediction the legal consequences of the work.

First, one should have a clear understanding of the exact legal entities that will be parties to the contract. Corporations do business under a variety of legal names, including divisions, subsidiaries and affiliates. Partnerships are a different form of legal entity. Contracting with single individuals ought to raise questions about ability to pay, and financial guarantees.

The scope of the work should be detailed. Just as importantly, the outer boundaries of the project should be delineated, i.e., the type of work which is *not* included in the contract. Where the professional services will be performed is a factor that will have a bearing on what state law applies in the event of a dispute. It is a good idea to put in a forum clause stipulating where the resolution of any disagreements will be heard.

If goods are going to be provided along with the contract performance, the type of products should be itemized and distinguished from the services performed. A professional does not ordinarily warrant the integrity of products supplied, so side agreements should be reached with those vendors involved.

Guarantees should never be made in a professional services contract, and limitation of liability and disclaimer clauses ought to be seriously considered and implemented in such agreements. Unlike accidents between two strangers, the professional services engagement may include these special clauses, and courts are especially likely to uphold them if the contract is between two sophisticated parties. Arrangements can also be made for indemnity, hold harmless, and additional insurance status.

If ADR is desirable, the contract may include a passage about arbitration or mediation. There are pros and cons to doing this, so be sure you want what you are asking for. Further, it is beneficial to anticipate what could happen in a multi-party project if others are involved or brought into the controversy. A linear professional services contract will have no bearing on the right of others to assert cross-claims as most states have some form of "joint and several" law that basically allows for a party to only pay for its own fair share of damages, so the arrangement should account for these contingencies.

All of these and more points are best included in a 'scope of representation' letter. While these can be drafted with excessive detail, some sort of written agreement is better than none. Failure to anticipate foreseeable risks

and common disputes is a far less desirable situation than preparing an agreed, reliable contract ahead of time.

CAUSES OF ACTION

Contract formation is best done with a clear understanding of what sort of theories might be brought against the professional in the event of a lawsuit. Some of the more common ones follow.

Breach of contract is a typical claim. Remember that a contract can be oral, based upon a formal, written agreement, or created through various documents that the courts construe as a contractual understanding. These might include purchase orders, invoices, emails, and correspondence. If a formal written agreement does not exist, any documentary evidence shedding light on the parties' intent will become evidence that is considered to determine what actual agreement was reached.

Historically, one of the most significant barriers to recovery has been the doctrine of 'privity'. If the parties were not in contract with each other, it was thought that no rights flowed between them. The courts have largely done away with this requirement. Now, third party beneficiaries may recover, as might any other damaged person or entity within the ambit of foreseeable harm, such as creditors, investors, or a bankrupt estate.

Some jurisdictions still require privity between parties. For example, under Illinois law, professional accountants may not be held liable to persons with whom they did not contract unless the accountant was aware that the client's primary intent was to benefit or influence a third party.[5] Questions of foreseeability, timing, and reliance are crucial elements in determining whether the ambit of anticipated harm included the plaintiff who places reliance on this doctrine.[6] For example, although an unidentified buyer may still be a known party, third parties alleging professional negligence against an accounting firm must still demonstrate a nexus between themselves and the accounting firm inviting reliance beyond the mere fact that accounting figures, once written down, may be read by anyone.[7]

Many states permit a **negligence** cause of action against the professional. Unlike a contract breach claim, negligence is governed by a different statute of limitations and is not subject to limitations of liability or disclaimer clauses. Third parties – those who did not contract with the professional – are more likely permitted to sue if certain qualifications are met. In professional negligence cases, the standard of care requires the defendant act with the same degree of knowledge, skill and ability as an ordinarily careful professional would exercise under similar circumstances.

Generally, expert testimony is necessary in professional negligence cases to establish the standard of care,[8] though experts for hire are pretty easy to find these days. For these and other reasons, a negligence claim, i.e., failure to abide by that standard of care expected of a professional under the same or similar circumstances, is thought to be a relatively more liberal form of recovery.

Misrepresentation is often pled in suits against professionals. Many state laws now have provisions allowing for this sort of claim. Often it appears that the deck is stacked against the defendant, as for instance, when performance turns out to be unsatisfactory it would seem that of course the end result was not accurately portrayed. But the one who performed the contract did not know that at the time. After all, who does not tout and defend his work until shown otherwise?

Courts have split on the application of consumer protection-type statutes to the learned professional.[9] The Restatement 2d. of ____ § 552 defines actionable negligent misrepresentation as misrepresentation where *pecuniary loss* results from the supplying of false information to others for the purpose of guiding them in their business transactions.[10]

These cases may turn on the scope of duty owed. A real estate professional may, for example, be bound to disclose known facts material to a transaction, but may not have a duty to independently search for more relevant information.[11] Additionally, an architectural firm may not owe a duty to the public to report or make safe any hazards it detects in a public project if the contract did not specifically require the architect to address safety issues.[12]

Breach of fiduciary duty is a common complaint. Be sure that there is in fact a fiduciary relationship between the parties; this might not always be the case, even though marketing and promotional materials may tout the trustworthiness or confidentiality of the relationship.[13] A recent Supreme Court case broadened the fiduciary duties of a 401(k) plan administrator.[14] The decision also illustrates how the legislation establishing the scope/breadth itself contains liability-creating provisions and formulas for damages.[15] Evolving changes in the market create new opportunities for individual suits.

In order to establish a fiduciary relationship, the allegedly superior party must have accepted a duty to guard the interests of the dependent party.[16] A breach of fiduciary duty claim can, for example, be claimed against attorneys. However, the attorney must take part in reciprocal activity or transaction affecting the parties to a suit in order to be liable.[17] Attorneys do not owe a fiduciary duty to their clients when the client undertakes a transaction without the participation of counsel. While Restatement of _____§ 126 places the burden on an attorney who enters into a transaction with a client to show that he did not impose undue influence on the client, some states have not yet adopted Restatement § 126 as law.[18]

Aiding and abetting claims have been made against attorneys[19] and theoretically could be against others. A more serious sort of claim is for **fraud**. Bear in mind that fraud claims typically must be pled with particularity, including "who, what, when, where and how..." details. That is, the exact words constituting fraud and the person who expressed them must be named in the complaint. If not, these claims fail. The U.S. Supreme Court recently limited fraud causes of action in a securities class action.[20]

In addition to actual fraud, **constructive fraud** can also be claimed. However, this type of claim requires the existence of a confidential or fiduciary relationship.[21] The plaintiff in these cases must show both that the defendant breached a fiduciary duty owed to the plaintiff and that the defendant knew of the breach and accepted fruits of the fraud.[22]

By definition, professionals are regulated and often licensed. In fact, a contract may not be enforceable, or liability exposure may be greater, if the professional doing the work is not properly licensed.[23] The state statutes and administrative rules setting up the special status of the professional usually contain definitions and standards of care. These are tools used both by the plaintiff and defense in professional liability suits. Care should be taken to see if a regulation allows for a private cause of action.[24]

A profession's own code of ethics has been used to support a case of professional liability.[25]

If there was something about the transaction that disparaged another person or the company's goods and services, a **defamation** claim might be brought. "Libel" is a word that means written defamation, and "slander" is oral defamation. Defamation is thought to be an intentional act in many states, so proof of it requires evidence of the requisite state of mind.

Liability of the entity that employs the alleged wrongdoer is often at issue, as the corporation or partnership usually has 'deeper pockets'. Though the E&O policy for the entity may well be triggered, state laws may provide protection to fellow shareholders, partners, and employers. Nonetheless, allegations of vicarious **negligent hiring, training, or supervision** are therefore common and provide a favorite theme in many cases. Success depends upon the type of profession at issue and the regulations affecting it.[26]

Though not a cause of action per se, anytime that a **conflict of interest** is apparent from professional dealings some sort of recourse would seem appropriate. Courts are prone to fashion a remedy when a conflict of interest exists.[27]

DEFENSES

One of the first things to do is define whether the act or omission at issue was truly professional in character. If it was mundane or ministerial type behavior then it will not be deemed "professional" by the courts. If, on the other hand, the activity involved services of a higher intellectual nature, then it is more likely considered professional.

Early consideration should be given to whether the case was started on time. **Statutes of limitations** exist to prevent suits involving stale claims, as memories fade over time and witnesses become unavailable. Different claims or causes of action have different statutes of limitations, so it is not uncommon to have part of a case dismissed.

If a particular issue controls the outcome of the whole case, the defendant may seek to **bifurcate** or split off that issue and have it determined at an early stage. Courts are often receptive to this because it leads to judicial economy. A "stay" or "hold" can be put on the rest of the case, and considerable cost savings may result to all parties and the judicial system.

Since the scope of a professional's duty is limited by contract or licensure, liability potential may be restricted by appropriate contract clauses. **Disclaimers**, caps on damages, and limitation of liability contract provisions may well be upheld by the court.[28] Indemnity or outright immunity may also be valid defenses.[29] Oftentimes it appears to professionals that the duty expected was performed, but the client did not take the professional's advice. Lawyers, accountants provided inaccurate information upon which the professional relied. **Contributory negligence** is therefore a defense. Any loss attributable to the suing party's own fault is not recoverable under the liability scheme of most states.

Mitigation is a concept akin to contributory negligence: if losses could have been avoided through reasonable precautionary steps those extra amounts are not recoverable. Damages that would have happened anyway are not allowed either.[30] Since the scope of a professional's duty is limited by contract or licensure, liability potential may be restricted by appropriate contract clauses. When dealing with the government, indemnity or outright immunity may be valid defenses.[31]

Sometimes bad results occur but they were predictable or forecast ahead of time. **Informed consent** may be a defense. If there were a knowing understanding of these risks by the aggrieved party and informed consent given in advance no recovery will be allowed. Surprisingly, the literature is sparse on the applicability of this doctrine to claims other than medical malpractice. Good communication throughout the engagement is key to a well-informed client and a successful relationship.

The test of **causation** is important: did the professional's wrongful act really cause the harm? In many malpractice settings the best procedure is to have a "trial within a trial." This would entail an initial resolution of the underlying dispute, only later (if necessary(get to the issue of whether there was a professional failure that caused or enhanced the loss.[32] A comparison between that which needs to be proven in a civil versus criminal attorney malpractice case is shown in *Winniczek v. Nagelberg* No. 04-2106 (7th Cir. 2005).

Plaintiff's efforts to use disciplinary rules or ethical standards as a cause of action are resisted—often successfully—by the defense. Generally it must be shown that these were meant to establish a standard of care. Even if this cannot be proven astute plaintiff attorneys may well find ways to introduce the standard as evidence one way or another.

Closely related to the causation defense are **public policy** positions. For example, emotional distress may not be recoverable unless the standard of care includes the duty to protect a client from that type of consequence.[33]

An earlier part of this article referred to the privity rule. That rule has been worn down over the years so the third parties might now have a right to recover. Consider, for example, the work of an attorney in drafting a will for a client. Upon death the beneficiaries who were aggrieved by some wrong in the drafting might have a cause of action, even though they were not clients of the lawyer. Some jurisdictions have statutes that limit such third party exposure. See, for example, the Illinois Public Accounting Act, 225 ILCS 450/30.1, and misrepresentations, fraud or contract claims.

The **economic loss doctrine** is a concept developed by the courts to distinguish between tort and contract law. When there is a contract, its terms should control the outcome rather than the looser rules of negligence. Cases involving the economic loss doctrine can become quite complex and call for clear legal guidance from the trial judge on motions. Included among the issues will be the distinction between products and services[34] and the interplay with insurance coverage.[35]

Buried deep within many administrative rules or state statutes are **immunity** provisions. These should be investigated carefully to determine if a suit is barred by some immunity law. Similarly, a federal law may **pre-empt** a state or local provision, meaning it will take priority. The doctrine of pre-emption is an important consideration when determining which law applies to a contract when agreements are drafted.

In most any case involving professional failings, expert proof is necessary. This is because the professional's work and skill are often beyond the understanding of most laypersons. The one limited exception to this general rule exists when "there is present

such an obvious and gross want of care and skill that the neglect to meet the standard of care is clear even to a layperson."[36] The case should be prepared from the beginning with appropriate expert assistance. If this is not done, or if the expert has not relied upon and employed rigorous scientific principles, the case may collapse.

Professional associations, recognizing that their own have testified against others in the occupation, have set standards to rein in or at least provide guidance to those who act as experts.[37] The court in *MacGregor v. Rutberg* held that association rules did not provide a cause of action for third parties.[38]

Sometimes administrative action precedes a civil lawsuit. These proceedings should not be taken lightly. A determination in that action could either be evidence in or have a conclusive effect on later civil proceedings. Counsel should be contacted upon commencement of any administrative proceedings.

INSURANCE COVERAGE

After the initial determination is made about whether professional services are truly involved one will be better able to determine who to tender the defense to for insurance coverage. Typically professionals will have a general liability policy and a professional liability policy. Each are supposed to cover different things; there should be neither gaps nor overlaps (at least if the insurance intermediary that helped procure the policy acted with due care!)

In fact, the general liability policy often has a professional services exclusion. Given the importance of coverage it is not uncommon to tap into either or both policies. A body of coverage law will determine the outcome.[39] Professional liability insurance can be expected to finance economic losses that GL policy may exclude, and have other valuable coverage provisions.

Often the exclusion is undefined, which could make it inapplicable. The phrase "arising out of" is frequently employed in insurance policies and it has been held by many courts to have a broad meaning. Nonetheless it may not apply to negligent hiring or supervision.

Often coverage realities have an important bearing on liability. For instance, whether the wrongful act was a "professional service" is an issue that often needs to be defined both for the liability and damages part of the case as well as for coverage.[40] Keep in mind that the insurer may be adverse to the professional on this and similar issues, creating unique and unhelpful conflicts. Another conflict is inherent in the appointed defense counsel role when coverage is questionable; it is avoided by a clear engagement letter and selection by the insured of separate counsel experienced with handling coverage matters.

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FOOTNOTES

1 See, e.g., Data Processing Services v. L.H. Smith Oil Corp., 492 N.E.2d 314 (Ind. Ct. App. 1986) (Sale of Software).
2 *Thomas, Lord of Shalford v. Shelley's Jewelry, Inc.*, 127 F. Supp.2d 779 (W.D. N.C. 2000).
3 121 ALR 5th 365
4 Vallens, "The Importance of Reputation," Risk Management Magazine (April, 2008).
5 *Tricontinental Industries, Ltd. v. Anixter*, 370 F.Supp.2d 742 (N.D.Ill.,2005).
6 *Display Promotions, Inc. v. Dovebid Valuation Services, Inc.* 704 N.W.2d 423 (unp. Wis. App. 2005); *Decatur Ventures LLC v. Daniel*, 485 F.3d 387 (7th Cir. (Ind.), 2007).
7 *Xerion Partners, LLC v. Resurgence Asset Management, LLC*, 474 F.Supp.2d 505 (S.D.N.Y.,2007).
8 See, e.g., *Longnecker v. Loyola Unviersity Medical Center*, 891 N.E.2d 954 (Ill. App. Ct.1 Dist.); *Cessna Aircraft Co. v. Avior Technologies, Inc.*, --- So.2d ----, 2008 WL 2356676 (Fla. Dist. App. Ct. 3).
9 *Compare Moore v. Bird Engineering Co.*, 41 P.3d 755 (Kan. 2002) with *RCDI Const., Inc. v. Space/Architecture Planning & Interiors*, P.A. 29 Fed.Appx. 120 (4th Cir. (NC) 2002).
10 *See Michael v. Huffman Oil Co.*, Inc., 661 S.E.2d 1 (N.C. Ct. App., 2008).
11 *See Hermanson v. Tasulis*, 48 P.3d 235 (Utah 2002).
12 *See Dukes v. Philip Johnson/Alan Ritchie Architects, P.C.*, 252 S.W.3d 586 (Tex. App., 2008).
13 *See Lyerla v. AMCO Ins. Co.*, 536 F.3d 684 (7th Cir. (Ill.) 2008).
14 *LaRue v. DeWolff*, 128 S.Ct. 1020 (2008).
15 *See also Beyer v. Heritage Realty, Inc.*, 251 F.3d 1155 (7th Cir. 2001) (RESPA).
16 *Joyce v. Morgan Stanley & Co.*, --- F.3d ----, 2008 WL 3844111 (7th Cir. (Ill.) 2008), citing *Pommier v. Peoples Bank Marycrest*, 967 F.2d 1115,1119 (7th Cir. (Ill.) 1992).
17 *Berner Cheese Corp. v. Krug*, 752 N.W.2d 800, (Wis. 2008).
18 *Id.* at PP 42.
19 Douglas Richmond, Lawyer Liability for Aiding and Abetting Clients' Misconduct under State Law, 75 Def. C.J. 130 (April 2008).
20 *Storewide Investment v. Scientific Atlanta*, 128 S.Ct. 761 (2008); *Tricontinental Industries, Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824 (7th Cir. (Ill.), 2007) (holding that an interest in fee income, by itself, is not enough to establish fraudulent intent).
21 *Joyce v. Morgan Stanley & Co.*, --- F.3d ----, 2008 WL 3844111, (7th Cir. (Ill.), 2008).
22 *Id.*, citing *Prodromos v. Everen Secs., Inc.*, 793 N.E.2d 151, 158 (Ill. App. Ct. 2003).
23 *Elephant Lumber Co. v. Johnson*, 202 N.E. 2d 189 (Oh. App. 1964); *Hickey v. Sutton*, 210 N.W.2d 704 (Wis. 1926).
24 *Lombardo v. Albu*, 14 P.3d 288 (Ariz. 2000) (department of real estate administrative regulation may form basis for standard of conduct).
25 *Menzel v. Morse*, 362 N.W.2d 465 (Iowa 1985); *Crutchley v. First Trust and Savings Bank* 450 N.W.2d 877 (Iowa 1990). *Compare Peck v. Meda-Care Ambulance Corp.* 156 Wis.2d 662, 457 N.W. 2d 538 (Wis. Ct. App. 1990) and *Hart v. Comerica Bank* 957 F.Supp. 958 (E.D. Mich. 1997.)
26 See, e.g. *Decatur Ventures LLC v. Daniel*, 485 F.3d 387 (7th Cir. (Ind.), 2007).
27 *Burrow v. Arce*, 997 S.W.2d 229 (Tex. 1999); *Guardian Pipeline, L.L.C. v. 950.80 Acres of Land*, 525 F.3d 554 (7th Cir. (Ill.), 2008); Thompson DF, Understanding Financial Conflicts of Interest, *New England Journal of Medicine*. 1993; 329 (8); 573-576.
28 Baliga, *Journal of Accountancy*, Vol. 181, 1996.
29 *Boyle v. United Technologies Corp.*, 487 U.S. 500 (1988); *Estate of Lyon v. CNA Companies*, 558 N.W.2d 658 (Wis. Ct. App. 1996);
30 *Maxwell v. KPMG*, 520 F.3d 713 (7th Cir. (Ill.), 2008).
31 Estate of Lyon, 558 N.W.2d 658; Boyle, 487 U.S. 500.
32 John M. Palmeri & Franz Hardy, "Application of the 'Case within a Case' Standard," For the Defense, (March 2008).
33 *Rathegeber v. James Hemenway, Inc.*, 69 P.2d 710 (Or., 2005).
34 See *Aslani v. Country Creek Homes*, 746 N.W.2d 605 (Wis. Ct. App. 2008) (Unp.); *RotoZip Tool Corp. v. Design Concepts , Inc.* 713 N.W.2d 191 (Wis. Ct. App. 2006) (Unp.).
35 Recent Posner decision 7th Circuit. *Arpin v. U.S.*, 521 F.3d 769 (7th Cir. (Ill.) 2008).
36 *Ackerly and Brown, LLP v. Smithies*, 952 A.2d 110 (Conn. App. Ct. 2008).
37 See, e.g., KS Kesselheim, and DM Studdert, Role of Professional Organizations in Regulating Physician Expert Witness Testimony, 298(24) NEUROLOGY 2907-2909 (2007); Williams MA, Mackin GA, Beresford HR, et al. American Academy of Neurology Qualification and Guidelines for the Physician Expert Witness, 66(1) NEUROLOGY, 13-14 (2006).
38 *MacGregor v. Rutberg*, 478 F.3d 790 (7th Cir. (Ill.) 2007).
39 See, e.g., *STHudson Engineers, Inc. v. Pennsylvania National Mut. Cas. Co.*, 909 A.2d 1156 (N.J. Super., 2006).
40 *PMI Mortgage Insurance Co. v. American International Insurance Co.*, 394 F.3d 761 (9th Cir. (Cal.) 2005).