Professional Liability

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Determining the Trigger Date for the Statute of Limitations in an Accounting Malpractice Action

All defense practitioners who represent accountants and attorneys know that one of the first things defense counsel must consider in every malpractice case is whether the complaint was timely filed. It is therefore imperative that every defense practitioner be aware of the very recent decision by the Appellate Court, First District, in SK Partners I, LP v. Metro Consultants, Inc., 2011 WL 636941 (1st Dist. Feb. 2011). It is not so much that SK Partners creates new law; instead, the decision approaches the statute of limitations issue in a very straightforward manner that may be applicable to other situations as well.

The fact pattern in SK Partners is not uncommon for an accounting malpractice case. SK Partners I through IV and Sal’s Holding Company (collectively, “the plaintiffs”) were related entities that owned real estate. The plaintiffs retained Metro Consultants, Inc. (“Metro”) to provide accounting services. Metro prepared the plaintiffs’ tax returns for the tax years 2000, 2001 and 2002. Thereafter, the plaintiffs retained the accounting firm CBJS to perform accounting services to the plaintiffs. Jeffrey Stuart of CBJS primarily worked on the plaintiffs’ matters.

After CBJS was retained, Stuart reviewed the plaintiffs’ tax returns that had been prepared by Metro. In so doing, Stuart found that errors had been made with respect to the cost basis that was used for calculating depreciation on different assets. Stuart believed that the depreciation of the plaintiffs’ real estate assets was understated, which caused the tax returns to overstate income, resulting in a greater tax liability for the plaintiffs. Stuart believed that the error was carried through all of the tax returns prepared by Metro. Stuart advised the plaintiffs of his findings in November 2003. He further advised at that time that it could take up to a year to properly investigate the issues and file amended tax returns.

Ultimately, amended tax returns were filed for the plaintiffs in September and October 2004. The Internal Revenue Service (“IRS”) thereafter conducted an audit, and subsequently issued a series of refund checks, the first of which was received in December 2004.

In September 2006, the plaintiffs filed suit against Metro for accounting malpractice asserting that Metro was negligent in the preparation of the plaintiffs’ tax returns. The plaintiffs alleged that after discovering Metro’s negligence, they were forced to amend their tax returns. They further alleged that they were damaged as a result of losing the depreciation deductions, incurring legal and accounting expenses, and losing the interest and economic value of the money that was overpaid to the IRS.

Metro moved to dismiss the plaintiffs’ complaint contending that the plaintiffs failed to file the action within the two year statute of limitations set forth in Section 13-214.2(a) of the Code of Civil Procedure. 735 ILCS 5/13-214.2(a). The trial court agreed that the plaintiffs had failed to timely file their complaint, and dismissed the accounting malpractice claim with prejudice.

On appeal, the plaintiffs asserted that the trial court erred in dismissing their complaint. The plaintiffs argued that under the discovery rule incorporated within Section 13-214.2(a), their claim was brought timely. The plaintiffs asserted that the statute of limitations did not commence until December 2004, when the first
refund check was issued by the IRS, because that was when they had actual knowledge of damages caused by Metro’s conduct. Based on a December 2004 commencement date, the plaintiffs argued that the filing of their complaint in September 2006, was timely under the statute.

The SK Partners court rejected the plaintiffs’ position. In analyzing the issue, the court initially began by discussing the holding in Federated Industries, Inc. v. Reisin, 402 Ill. App. 3d 23 (1st Dist. 2010). Federated Industries involved an accounting malpractice claim that was based on a tax deficiency, rather than a tax overpayment as in SK Partners. The court in Federated Industries held that “the statute of limitations in an accountant malpractice case involving increased tax liability begins to run when the taxpayer receives the statutory notice of deficiency ... or at the time when the taxpayer agrees with the IRS’ proposed deficiency assessments.” Federated Industries, 402 Ill. App. 3d at 36. The SK Partners court then drew a distinction between the issue presented by the plaintiffs and the issue presented in Federated Industries. The SK Partners court stated that the “case sub judice, however, is clearly distinguishable because it does not involve a tax deficiency that was first noticed by the IRS, but rather an overpayment of taxes first noticed by a different accountant.”

The court then used this distinction to reject the plaintiffs’ contention that they did not have actual damages until the IRS accepted their amended tax returns and made the first refund. Because Metro’s error resulted in an overstatement of income and, therefore, an overpayment of taxes, “actual damages occurred at the moment taxes were overpaid.” This is because the overpayment of taxes “immediately deprives the taxpayer of income that was rightfully his to retain in the first place.” SK Partners, 2011 WL 636941 at *3. The court further noted that contrary to the plaintiffs’ contention that actual damages were not sustained until the first refund check was received, the receipt of the refund check increased the plaintiffs’ monetary assets and “is essentially mitigation of the damages that already occurred, i.e., the overpayment of taxes.”

Applying these principles, the court held that the plaintiffs had knowledge by November 2003, that the earlier tax returns were problematic. By that time Stuart had communicated his knowledge to the plaintiffs, and they had an obligation to inquire further into the claim. The statute of limitations, therefore, was triggered at that time. While the court made clear that the statute of limitations does not necessarily begin to run in every case as soon as an accountant notifies a client of “a possible previous accounting error,” the court believed that the information provided to the plaintiffs by Stuart was sufficient to trigger the statute of limitations.

Alternatively, the court held that if the statute of limitations was not triggered in November 2003, it certainly was triggered in September 2004, when the first amended tax return was filed. The court found that it was “plainly obvious” by then that there was a tax overpayment. The court thus held that “the statute of limitations expired at the latest by September 11, 2006, but most likely by November 11, 2005.” Because the plaintiffs’ complaint was filed after both dates, the plaintiffs’ complaint was untimely.

After setting forth this holding, however, the court went on to address the plaintiffs’ assertion that the court should analogize their case to attorney malpractice cases. In particular, the plaintiffs believed their situation was similar to that presented in Warnock v. Karm Winand & Patterson, 376 Ill. App. 3d 364 (1st Dist. 2007). In Warnock, the defendant attorney had drafted a real estate contract for the plaintiff which included a liquidated damages provision. The liquidated damages provision was found unenforceable by a court, and the plaintiff sued the defendant for malpractice. In determining when the statute of limitations began to run in the legal malpractice case, the Warnock court held that it did not begin to run until the court’s determination that the provision was unenforceable, as opposed to when the lawsuit was initiated, because at that time the lawsuit was filed “there were no actionable damages.” Id. at 371.

The plaintiffs also analogized their case to the principles in Lucey v. Law Office of Pretzel & Stouffer, Chartered, 301 Ill. App. 3d 349 (1st Dist. 1998). The Lucey court held that “a cause of action for legal malpractice does not accrue until a plaintiff discovers, or within a reasonable time should discover, his injury and incurs damages directly attributable to counsel’s neglect.” Id. at 353. The Lucey court further stated that a claim for legal malpractice rarely accrues prior to entry of an adverse judgment, settlement or dismissal of the underlying action which gives rise to the claim for legal malpractice. The plaintiffs in SK Partners argued that similarly, their damages were not realized until the IRS sent the initial refund check to them.
The SK Partners court rejected the analogy. The court stated that legal malpractice cases are analogous to tax deficiency cases where the negligent conduct is suspected before actual damages occur and are ascertainable, through a tax deficiency or an adverse judgment. In contrast, the court found that “medical malpractice cases would be more similar to the overpayment cases because actual damages in the form of the tax overpayment or bodily injury occur before the related negligent conduct is suspected.” The SK Partners court thus held, “we reject plaintiffs’ argument that we must adopt principles similar to those in legal malpractice cases in circumstances where a taxpayer has overpaid taxes due to accounting malpractice.”

The court’s distinction between taxpayer deficiency cases and taxpayer overpayment cases, and the analogy of those cases to legal malpractice and medical malpractice cases, respectively, is interesting. The court has provided a framework for determining the trigger date of the statute of limitations in each distinct type of case. While there may be nothing particularly novel about the court’s holding, I believe this framework may be helpful to practitioners who defend these types of claims.

About the Author

Martin J. O’Hara, a Principal in Much Shelist Denenberg Ament & Rubenstein, P.C.’s Litigation & Dispute Resolution practice group, concentrates his practice on commercial litigation and the defense of professionals in malpractice actions. Mr. O’Hara earned his B.A. in 1990 from Illinois State University and his J.D. in 1995 from the John Marshall Law School. He is a member of the Illinois State Bar Association, the Chicago Bar Association, the Defense Research Institute, the Illinois Association of Defense Trial Counsel and the Society of Trial Lawyers. While in law school, he served on the John Marshall Law Review, and won a Graduate School Scholarship Award and the Dean Herzog Scholarship.

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