

# Fraud Conviction Entitles Insurer to Rescind Malpractice Policy and Recoup Previously Advanced Defense Costs

---

February 2007

The United States District Court for the Southern District of New York, applying federal and New York state law, has held that a legal malpractice policy was void from its inception where the attorney who signed the application denied knowledge of circumstances that could give rise to a claim in the application while at the same time the attorney was engaging in fraudulent activities. *Chicago Ins. Co. v. Fasciana*, 2006 WL 3714310 (S.D.N.Y. Dec. 13, 2006).

The attorney signed a professional liability policy application on behalf of himself and his law firm. As part of the application, the attorney denied knowledge of any circumstance that might give rise to a claim. Subsequently, prior to the expiration of the policy, the attorney was indicted on multiple counts of fraud for his participation in a scheme to make it appear that the firm's client had collected more than \$350,000 in receivables by laundering money through the firm's bank. The carrier provided the attorney with a defense in that proceeding under a reservation of rights. After trial, the attorney was convicted of multiple counts of fraud. Following the trial, the insurer brought a rescission action based on the misrepresentations made in the policy application.

Applying federal law on collateral estoppel, the court held that the attorney was estopped from denying knowledge of the fraud when he signed the application, citing the multiple convictions for fraud. The federal standard governing collateral estoppel in diversity actions requires that (1) the issues be identical, (2) the issue in the prior proceeding was actually litigated and decided, (3) the prior proceeding must have provided a full and fair opportunity to litigate the issue, and (4) the issue previously decided must have been necessary to the final adjudication on the merits. As to the identity of the issues, the court determined that the issues were identical because it was determined in the criminal proceeding that the attorney knowingly and willfully committed fraud in the years preceding the application. The instant action, likewise, concerned the attorney's knowledge of circumstances that could give rise to a claim. Given that the attorney was convicted of knowingly participating in a fraudulent scheme, the court concluded that the attorney clearly knew of circumstances that could give rise to a claim. As to the second and third elements, the court likewise determined that they were satisfied by the criminal trial and resulting verdict. Finally, the court held that the issue of the attorney's knowledge of the scheme was necessary to the final adjudication because the

attorney's knowing participation in the fraud was a necessary element in the crime charged.

Applying New York law on the remaining issues, the court concluded that the misrepresentation in the application was material. The court explained that, under New York law, a misrepresentation is material if the insurer would not have issued the policy if it had known the truth. The court further stated that the insurer was not required to show that it would not have issued any policy, only that it would not have issued the policy as it was ultimately issued. Because the underwriter had submitted an affidavit stating that he would not have issued the same claims-made policy had he known that the attorney knowingly engaged in a fraudulent scheme, the court concluded that the insurer had established the materiality of the misrepresentation.

In an attempted rebuttal, the attorney contended that an unnamed agent from the insurer told him to disclose matters only when he "had a current belief of an impending or likely claim" and not every single possible claim. The court rejected the affidavit because (1) it was hearsay, and (2) the application contained an integration clause precluding reliance on the oral modifications alleged by the insured.

The court also rejected the attorney's argument that the insurer had unclean hands because it refused to return the policy premiums for the five prior policies. The court determined that argument to be without legal support and also noted that the attorney could have filed a counterclaim for those amounts but failed to do so. Similarly, the court stated that the attorney's argument that the carrier was estopped from rescinding because it had provided a defense in the underlying action was without basis, as the carrier had reserved its rights in connection with providing that defense.

Finally, because the policy was void from its inception, the court held that the insurer was entitled to reimbursement for legal fees paid by it on the attorney's behalf.