

Law Firm and Lawyer's Estate Not Entitled to Coverage for Amounts Borrowed and Not Repaid to Former Clients

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The United States District Court for the Middle District of Pennsylvania, applying Pennsylvania law, has held that an insurer had no duty to defend or indemnify the estate of a lawyer and a law firm in connection with a suit brought by former clients of a deceased lawyer to recover amounts borrowed but not repaid by the lawyer. *Westport Ins. Corp. v. Hanft & Knight, P.C.*, 2007 WL 4296614 (M.D. Pa. Dec. 10, 2007).

In the underlying action, the former clients alleged that the lawyer, who later committed suicide, induced them through "false misrepresentations and abuse of the attorney-client relationship" to lend the lawyer money, some of which was used to gamble and satisfy gambling debts. As against the lawyer's estate, "the former clients demanded the return of all unpaid funds borrowed by [the lawyer] under false pretenses." The former clients further alleged that the law firm failed adequately to supervise the lawyer, breached its fiduciary duty to them, and violated the Pennsylvania Unfair Trade Practices and Consumer Protection Law. Both the estate and the law firm tendered the suit for coverage under a legal malpractice policy issued by the insurer to the law firm.

The insurer brought an action seeking a declaration that it owed no duty to defend or indemnify either the estate or the law firm in the underlying lawsuit. The court first rejected the insurer's argument that the underlying complaint sought restitution, which did not constitute "loss" under the policy. In so holding, the court noted that the professional malpractice and breach of fiduciary duty counts against the law firm sought compensatory damages, which "[o]n their face, . . . seek 'loss' within the terms of the policy." The court also rejected the insurer's contention that coverage was barred for the underlying action on public policy grounds. In so holding, the court noted that the law firm had not benefited from the loans to the lawyer and indemnification of a judgment requiring the firm to pay the plaintiffs would result in no windfall to the firm. According to the court, "at least some of the claims in the underlying complaint seek 'loss,' the indemnification of which is not barred by public policy, and, therefore, these claims come within the broad coverage provided" by the policy.

After concluding that the underlying action potentially fell within the scope of the policy's coverage grant, the

court turned to the policy's exclusions and determined that four separate exclusions each applied to bar coverage for the underlying action. First, the court held that the policy's personal profit exclusion barred coverage because the underlying complaint clearly alleged that the attorney gained a personal profit from his conduct. The former clients argued that the exclusion did not apply because the exclusion only applied if the insured "gained in fact any personal profit or advantage to which he or she was not legally entitled," noting that there had been no "in fact" determination of personal profit. The court rejected this argument, holding that the allegations and evidence in the underlying complaint made it clear that the attorney personally profited from his acts and there was no evidence disputing these allegations. The court noted that it was unlikely that a final adjudication of these issues would ever occur, and thus a "final adjudication" interpretation of the "in fact" language would impermissibly render the exclusion meaningless.

Second, the court held that the policy's prior knowledge exclusion barred coverage. The court held that, in order to demonstrate the requisite prior knowledge, the insurer must show that: (1) the attorney subjectively knew of certain facts prior to the effective date of the policy; and (2) a reasonable lawyer in possession of such facts would have had a basis to believe that the insured had breached a professional duty. The court held that the insurer had met this burden by demonstrating that the insured had sufficient knowledge to believe that he had breached his professional duty prior to the effective date of the policy.

Third, the court held that the policy's dishonesty exclusion barred coverage. The court held that the underlying complaint clearly alleged dishonest acts by the deceased lawyer. The former clients argued that the exclusion should not apply because the exclusion stated that it "does not apply to any Insured who is not so adjudged." The court rejected the argument that this language required an adjudication of dishonesty. The court noted that, for the underlying complaint to be successful, it would necessarily involve a finding of dishonesty. In addition, the court noted that an adjudication requirement would effectively write the exclusion out of the policy. Finally, the court noted that, although a final jury verdict in the underlying action might not make a finding of dishonesty, it was appropriate to characterize the claims against the lawyer in the underlying complaint for what they were, "the disreputable and dishonest behavior of a lawyer gone bad."

Fourth, the court held that an exclusion barring coverage for "any Claim based upon, arising out of, attributable to, or directly or indirectly resulting from any conversion, misappropriation or improper commingling of client funds" applied to bar coverage for the underlying action. Although the terms were undefined in the policy, the court looked to Pennsylvania law to determine the meaning of conversion and misappropriation. Applying the meaning of those terms to the plaintiffs' allegations against the lawyer, the court determined that the plaintiffs' underlying claims arose out of conversion and misappropriation and were thus barred from coverage. The court again rejected the argument that the inclusion of the sentence "[t]his exclusion does not apply to any Insured who is not so adjudged" in the exclusion requires an actual adjudication before the exclusion can be applied to bar coverage.

Finally, the court held that the language of the personal profit and prior knowledge exclusions applied to the claims against the law firm, even though the law firm was a so-called "innocent insured." The court held that

these exclusions applied because the unambiguous language of the exclusions required only that "any Insured" profit or have the requisite knowledge. Here, because the lawyer, an insured, so profited and had the requisite prior knowledge, the exclusions applied to bar coverage for the entire action.