

Return of Clients' Funds Appropriated By Rogue Employee Constitutes Covered Loss

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The United States District Court for the Southern District of Florida has held that factual issues prevent summary judgment on whether the policyholder had knowledge of a claim sufficient to trigger the prior knowledge condition to the policy's coverage grant. The court also held that the policy's definition of "damages" encompassed the return of funds that clients had deposited with the insured law firm because those funds had been misappropriated by a "rogue employee" without the insured lawyers' knowledge. *Am. Guarantee & Liab. Ins. Co. v. Cascoe*, 2010 WL 1976759 (S.D. Fla. May 17, 2010).

In an underlying action, claimants obtained a judgment against the policyholder law firm based on the loss of funds they had deposited with the firm in connection with a land transaction. Unbeknownst to the firm's lawyers, the firm's paralegal, operating in concert with a title company, set up various "false closings" in which the claimants' money was used to fund sham real estate transactions. The court in the underlying action ordered the insured to return the clients' deposits and to pay their costs of pursuing the underlying action.

The lawyers professional liability policy at issue required, as a condition precedent to coverage, that no insured "had any basis (1) to believe that any Insured had breached a professional duty; or (2) to foresee that any such act or omission or Related Act or Omission might reasonably be expected to be the basis of a Claim against any Insured." The district court concluded that the firm's lawyers' knowledge of whether they had breached any professional duty was a jury question. A lawyer's concession that he had released funds without specific written authorization was insufficient to support summary judgment because the lawyer "understood that we were ready to close" on the land at issue, and the lawyer did not, at the time of the application, have knowledge of his paralegal's and the title company's fraudulent actions.

The court did not address whether the paralegal's knowledge of the fraudulent scheme would trigger the "no insured" language of the prior knowledge condition. The court described the paralegal as a "rogue employee" who was conducting the unauthorized transactions that led to the judgment in the underlying action before the insurer issued the policy. The court also noted that the policy included the paralegal as an "Insured" only to the extent the paralegal was rendering legal services and acting within the scope of the paralegal's employment.

The policy carved out from its definition of "damages" any "personal profit or advantage to which the Insured was not legally entitled." The court rejected the insurer's argument that this clause and general Florida law of insurable loss barred coverage for the underlying "restitutionary" judgment against the policyholder. The court characterized the underlying judgment as one for negligence in failing to protect against a fraud committed by its employee, not as one for restitution of wrongfully retained funds. The law firm negligently permitted the clients' funds to be lost; it did not retain the clients' money, and therefore did not have the money to return.

The policy's definition of damages also carved out "legal fees, costs and expenses paid to or incurred or charged by the Insured. . . ." The court held that this provision precluded coverage for the portion of the judgment awarding costs of the underlying action, notwithstanding the fact that the claimants' costs were not paid to or incurred or charged by the insureds. The court explained this holding only by stating that the claimants did not present any argument on the issue.