wiley

NEWSLETTER

No Rescission Where Attorneys Unaware of Employee's $2.7 Million Embezzlement Scheme

October 2003

A Massachusetts appellate court has held that an insurer was not entitled to rescind a legal malpractice policy because the insured attorneys did not make misrepresentations in their insurance applications and because they were not on inquiry notice of an embezzlement scheme when they signed the applications. *Chicago Ins. Co. v. Lappin*, 792 N.E.2d 1018 (Mass. App. Ct. 2003). The court also held that the embezzlement scheme involved multiple claims under the Policy. Finally, the court made a number of rulings concerning coverage for prejudgment interest and attorneys' fees.

The insurer issued a claims-made legal malpractice policy to two solo practitioners who shared office space and often worked together on cases. The policy contained a limit of $1 million per claim, with an aggregate limit of $2 million. In connection with the renewal of the policy, the attorneys each submitted renewal applications on May 4, 1995. The applications asked: "Have any new claims or circumstances which may result in a claim arisen in the past policy period?" Both attorneys answered in the negative. They were issued a policy, which, according to the declarations page, commenced on May 10, 1995 for a one-year policy period. The policy was bound on May 10, 1995, activated on July 20, 1995, and physically delivered on August 8, 1995. The policy obligated the insurer to pay "all sums" the attorneys become "legally obligated to pay as damages." Additionally, the policy contained an endorsement that provided that "[p]rejudgment interest, where payable under this policy, will be in addition to the limits of liability stated in the declarations."

One of the attorneys hired a secretary and administrative assistant who was later found to have embezzled some $2.7 million from the attorney's clients. The trial court found that the attorneys were unaware of the embezzlement scheme at the time it took place and when they signed the renewal application. The attorneys first began to learn of the scheme on July 11, 1995, and they subsequently notified the insurer of the circumstances. After the attorneys were sued in connection with the embezzlement and tendered the complaint to the insurer, the insurer filed suit to rescind the policy, contending that the attorneys had made misrepresentations in answering the question on the application concerning new circumstances or claims that may result in a claim.

The court first rejected the insurer's argument that the attorneys should have disclosed two prior, unrelated matters. The first of these matters was a bar disciplinary proceeding brought by a client who demanded no relief; the second was a letter warning of future action from a client. The court reasoned that those matters

did not need to be disclosed because they were not "claims" within the meaning of the question on the application since the policy provided no coverage for such matters. The court explained that no coverage would have been available for the bar disciplinary proceeding because the person complaining to the bar "did not allege any injury and made no present demand for relief, either monetary or otherwise." The court explained that the second matter was "more in the nature of a request that the recipient complete unfinished work rather than a demand as of right." The court also rejected the insurer's argument that the two matters constituted "circumstances which may result in a claim," explaining that the attorneys "did not believe either [matter] could result in a claim because at the time of the application, both matters appeared to have been amicably resolved with only ministerial details yet to be completed."

The court declined to hold that the attorneys were on inquiry notice of the embezzlement scheme and should have detected warning signs concerning the secretary's conduct. Noting that whether notice is sufficient to charge a person with constructive knowledge is a question for the fact-finder, the appellate court declined to overturn the trial court's conclusion that the attorneys were not on notice even though different conclusions could have been drawn concerning the operative facts.

The court also rejected the insurer's argument that the policy's operative date was July 20, 1995, the date on which the policy was activated, and that the attorneys therefore should have updated their application after they learned of the embezzlement scheme on July 11, 1995. The court concluded, finding no policy language to the contrary, that the policy was operative on the date it was bound, May 10, 1995, not the day it was activated or physically delivered.

The court rejected the insurer's argument that the single claim limit of $1 million applied to the embezzlement scheme, accepting the trial court's conclusion that the attorneys had been negligent through multiple and unrelated breaches occurring over a period of many years rather than through a single breach. Accordingly, the $2 million aggregate limit was held to be applicable.

Finally, the court made a number of rulings concerning damages. The court held, relying on the insurer's obligation to pay "all sums," that the insurer was required to pay prejudgment interest and that the interest payments were not subject to the limits of liability under the policy. The court also held that the trial court had acted within its discretion when it awarded attorneys' fees and costs incurred in litigating both the coverage dispute and the underlying litigation to the policyholders. However, the court did hold that the fees incurred in defending the underlying action would come off of the policy limits. The court reasoned that, while the insurer declined to defend, it "at least acquiesced in defence [sic] of the insured by counsel retained by him." Finally, the court rejected an argument by the underlying plaintiffs that they were entitled to attorneys' fees and costs. The court explained that, although it was appropriate to award fees to a party that was supposed to benefit from the duty to defend–the insured–that logic did not hold with respect to the underlying claimants.

For more information, please contact us at 202.719.7130.