

ALERT

Misappropriation of Client Funds Entitles Insurer to Rescind Lawyers Policy and Does Not Satisfy Prior Knowledge Condition in Accountants Policy

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The United States District Court for the District of South Carolina has held that, based on an insured's admitted misappropriation of client funds, an insurer is entitled to rescind a lawyers professional liability policy, and that there is no coverage under an accountants professional liability insurance policy because the prior knowledge condition to coverage was not met. *Cont'l Cas. Co. v. Jones*, No. 3:09-cv-1004-JFA (D.S.C. Sept. 2, 2011). Wiley Rein represented the insurer in the litigation.

The insured operated a solo law practice and an accounting practice in which he partnered with another accountant. The insurer issued a lawyers professional liability insurance policy to the law practice. The insurer also issued two successive accountants professional liability insurance policies to the accounting practice. The accountants policies included a prior knowledge provision that conditioned coverage on no insured having a basis to believe that any "act or omission, or interrelated act or omission, might reasonably be expected to be the basis of a claim." The accountants policies also included an "innocent insureds" provision, which stated that "if coverage under this Policy would be excluded as a result of any criminal, dishonest, illegal, fraudulent or malicious acts of any of you, we agree that the insurance coverage that would otherwise be afforded under this Policy will continue to apply to any of you who did not personally commit, have knowledge of, or participate in such criminal, dishonest, illegal, fraudulent or malicious acts or in the concealment thereof from us."

Practice Areas

D&O and Financial Institution Liability
E&O for Lawyers, Accountants and Other Professionals
Insurance
Professional Liability Defense

The insured lawyer/accountant created one operating account for both the law firm and the accounting firm. Prior to the inception of both the lawyers policy and the accountants policies, the insured began misappropriating client funds. The insured's partner in the accounting practice had no knowledge of the thefts at the time. The thefts were discovered over a year and a half later, after the inception of the lawyers and initial accountants policies, and multiple lawsuits were filed against the insured lawyer/accountant, the law practice and the accounting practice. The insureds sought coverage under both the lawyers policy and the accountants policies.

In the coverage litigation that followed, the insurer sought to rescind the lawyers policy based on misrepresentations in the application regarding the insured's knowledge of circumstances that could give rise to a claim and based on the insured's false warranty statements that the responses on the application were accurate and that he had no knowledge of acts or omissions which a reasonable person would view as likely to give rise to a claim. The court held that the insurer was entitled to rescind the lawyers policy. In reaching this conclusion, the court stated that, although the standard for proving rescission based on a false warranty was much less burdensome than the standard for proving rescission based on a false representation, it was unnecessary to determine whether the insured's statements constituted representations or warranties because the undisputed facts established a basis for rescission under the more stringent standard applicable to misrepresentations. In this regard, the court noted that the insured had admitted that he stole money from law firm clients, that he knew that his misconduct would give rise to a claim, and that he lied on his application for the lawyers policy in order to defraud the insurer.

The insurer also sought a declaration that there was no coverage under the accountants policies because all of the claims arose out of interrelated acts or omissions (*i.e.*, the insured's misappropriation scheme), which began prior to the inception of the initial accountants policy and, thus, that policy's prior knowledge condition to coverage had not been met. The insured partner in the accounting practice, who had no knowledge of the thefts at the time they occurred, argued that the policy's innocent insured provision saved coverage for her and for the accounting firm and, alternatively, that the insurer was estopped from denying coverage based on actions it took in renewing the accountants policy and allowing the accounting firm to purchase tail coverage for the renewal accountants policy after it had knowledge of the insured's theft of client funds.

The court agreed with the insurer, holding that it had no duty to defend or indemnify any insured because, prior to the inception of the initial accountants policy, an insured had knowledge of his scheme "to defraud his clients of money and to cover his tracks," and all of the various clients' claims arose out of acts or omissions that were interrelated to this scheme. Accordingly, the policy's prior knowledge condition to coverage had not been met. The court further held that the accountants policies' innocent insured provision was inapplicable and did not save coverage for the innocent partner or the accounting firm because an insured had knowledge, prior to the inception of the accountants policy, that his misconduct might give rise to a claim. In reaching this conclusion, the court followed *Bryan Brothers, Inc. v. Continental Casualty Co.*, 2011 WL 1058851, — F.3d — (4th Cir., Mar. 24, 2011), which the court determined "aligns on all fours." (Wiley Rein represented the insurer in *Bryan Brothers*, a summary of which can be found in the April 2011 edition of *Executive Summary*.)

The court also rejected the insureds' estoppel argument and concluded that the renewal accountants policy and the tail coverage that was purchased at the expiration of that policy period remain in full effect and provide meaningful coverage for claims unrelated to the insured's misappropriation scheme.