Florida Appellate Review

Published By Dan Bushell

Malpractice Insurance Covers Client Trust Funds Lost in Scam, 11th Circuit Holds

Posted by Dan Bushell on June 13, 2011

If you're like me, some mornings you're greeted by an email that purports to be from a potential client (usually located in China, Hong Kong, or Japan) that reads something like this:

> Dear Counsel [or Sir or some other generic greeting],
>
> On behalf of XYZ Company, we request your legal services and possible representation on a Debt Recovery matter involving XYZ Company and a client in your jurisdiction.
>
> Do let us know if you are currently accepting new clients. We look forward to a prompt response from you. Thank you very much.
>
> Sincerely,
>
> [Mr. _____
>
> XYZ Company]

I'll admit that the first time I received such an email years ago, I entertained the idea, for a brief moment at least, that maybe, just maybe, it was legitimate inquiry. But then my inner skeptic took over, and I went right to snopes.com or some similar site to see if scams of this type were going around. They were, of course. I deleted the email and went back to the grind.

Now I just delete them as soon as they come in. As I'm sure you do. And as I thought every lawyer did.

But it seems that some lawyer or employee at a now-defunct central Florida law firm didn't listen to his or her inner skeptic when he/she received one of those emails back in 2007. Giving that person the benefit of the doubt, let's assume these scams weren't so well publicized back then.

The Scam

In any event, an inquiry came from Hong Kong asking the law firm to set up a U.S. subsidiary of a supposed Hong Kong parent company. The "client" subsequently sent a cashier's check to the law firm for a bit more than $197,000. The lawyer deposited it in the firm's lawyer's trust (IOTA) account. Before the check cleared, the client told the law firm to wire $180,000+ to other foreign entities.

The law firm proceeded to follow the client's directions. And because the law firm had enough funds from other clients in its IOTA account, the bank covered the wire transfers even though the original check hadn't cleared. The "client's" check, of course, never did clear.

The Insurance Coverage Dispute

Realizing it was short $180,000+ to its other clients, the law firm sought coverage from its malpractice insurer for their lost funds. [I imagine the adjuster's reaction went something like this: "You did what? You fell for one of those scams? And you want us to indemnify you for it?!"]

The insurer denied coverage. The law firm filed a declaratory judgment action in the Middle District of Florida. Judge Virginia M. Hernandez Covington granted summary judgment to the insurer.

In *Nardella Chong, P.A. v. Medmarc Casualty Insurance Co.*, No. 10-12237, decided May 27, 2011, the Eleventh Circuit reversed.

The Coverage Issues

The law firm's professional liability policy indemnified it for "Damages" – defined as "any compensatory monetary judgment or award, or any settlement consented to by the" insurer, resulting from alleged "negligent acts or negligent omissions," in "the performance of or failure to perform 'Professional Services.'"

"Professional Services" was defined as including, among other things:

"Services performed . . . for others as an attorney;" and "services as an administrator, conservator, receiver, executor, guardian, trustee, committee of an incompetent person, or services performed in any similar fiduciary capacity, but only for those services typically and customarily performed by and attorney."

In both the district court and the court of appeals, the case came down to two issues:

1. Did the law firm's acts and omissions occur in the course of performing "Professional Services"?

2. Did the money the law firm owed its other clients (i.e., the funds lost in the scam that it had to repay into its trust account) amount to "damages" as defined by the policy?

The district court answered "no" to both questions, but the 11th Circuit answered "yes."

The Court's reasoning, and my analysis, is below.

Analysis

Fiduciary duties. Funds held in trust. Damages versus restitution. This all reminds me of the time I spent litigating ERISA cases.

Anyone familiar with the Rules Regulating the Florida Bar, the ABA's Model Rules of Professional Conduct, or the Legal Ethics Rules of any other jurisdiction knows that managing funds held in trust for clients is one of attorneys' most sacred duties. And misappropriating client trust funds is among the offenses for which lawyers are most severely punished.

So you might think it obvious that the law firm's acts and omissions in managing its trust account (including in allowing the funds in the account to be fraudulently depleted) were undertaken in the course of performing Professional Services. Indeed, both the district court and the court of appeals noted that *Green v. Bartel*, 365 So. 2d 785 (Fla. 2d DCA 1978), established more than 30 years ago that lawyers wear their fiduciary hats when they hold and manage client trust funds, such that mismanagement can amount to legal malpractice in Florida.

But the alleged mismanagement in *Medmarc* was different from the mismanagement in *Green* and similar cases: the law firm followed the directions of all of its clients. And unlike in the typical case of trust fund-related lawyer discipline, no one commingled client funds with attorney funds, or syphoned off client funds for personal gain.

Here's where the underlying analysis reminds me of ERISA. In ERISA litigation, the main issue is often: Was the defendant acting as a fiduciary when it performed the action or omission? I understand the differing results reached by the district court and 11th Circuit here to have resulted from their different answers to an analogous question.

When a lawyer causes the loss of his/her client's money while taking (or failing to take) action with respect to that client's funds (e.g., disbursing a client's funds to third parties on the client's behalf, as in *Green*), the issue is simple. The lawyer is acting (or failing to act) in his/her capacity as a fiduciary of the funds of that client. But in *Medmarc*, the law firm was taking action in its capacity as fiduciary for one "client," but lost the funds of other clients.

So the real question was whether the law firm, when it took action for one client, was also acting in a fiduciary capacity with respect to all of the clients whose funds were being held in its trust account. The question results form the fact that although lawyers' trust accounts segregate clients' money from the law firm's money, they don't separate one client's funds from another's.

The district court apparently understood the law firm to be acting as a fiduciary only with respect to the client that directed it to disburse funds. The Eleventh Circuit, on the other hand, appears to have taken the view that any time a lawyer takes any action with respect to his/her trust account, he/she has fiduciary duties to each and every client whose funds are held in that account.

Having found that it was acting as a fiduciary for each of them at the time of the wire transfers, the court of appeals had no trouble concluding that the law firm was performing Professional Services for each of the clients whose trust funds it lost. So coverage was trigggered.

Damages or Restitution?

Ultimately, the question of damages vs. restitution collapsed into the fiduciary duty issue. The district court held that because the law firm didn't breach a duty to its clients, and the money was lost only through the acts of a third party, the law firm didn't damage the clients, so it couldn't be liable for "damages" to them. To the extent the law firm might be required to pay their funds back, the district court explained, it would only be as a matter of restitution.

Because the Eleventh Circuit held that the law firm did violate duties to the clients whose funds were lost, the district court's reasoning on the "damages" issue fell away with its conclusion on the fiduciary duty issue. It bears noting, however, that the policy defined "damages" fairly broadly, to include any "monetary judgment or award" or settlement that was compensatory in nature. So this argument seems to have been an unlikely winner from the outset.

An Insured Risk, But Still Not Worth Taking

If there's one lesson for lawyers from this case, it's this: Don't disburse your client's funds from your IOTA account unless you're sure that suficient funds attributable to that client are actually in your account!

At first glance, *Medmarc* seems to create a certain moral hazard in allowing lawyers to be indemnified for getting involved in these kinds of scams. If your losses will be covered, why worry about getting scammed? You may as well take the risk, right?

Well, no. Because the other implication of this decision is that by taking risks with your clients' trust funds, you're also taking the risk of marring your disciplinary record. No thanks.

Florida Appellate Review

Bushell Appellate Law, P.A.
2000 Glades Road, Suite 110 Boca Raton, Florida 33431