Arlington law firm loses malpractice coverage due to 'scheme'

BYLINE: Deborah Elkins

A new business client comes in. He has a great idea, a real moneymaker. He needs a lawyer to help him get his business up and running.

The client's excitement is contagious. Pretty soon, the lawyer wants a piece of the action. He decides to invest in the business.

Tread carefully if you head down this path. When you start to do business with a client, ethics rules aren't the only thing to worry about. The lawyer also needs to pull out his legal malpractice insurance policy and check for a "business exclusion" clause.

In a case reported Nov. 18, an Arlington law firm forfeited its malpractice coverage because of its lawyers' involvement with various business entities. The case deserves attention, according to the lawyer who represented the insurance carrier, because it's the first time a court has applied the business exclusion to a "loose enterprise," more akin to the common-law definition of a business enterprise, as opposed to a more formally organized business.

To decide the coverage issue in Minnesota Lawyers Mutual Ins. Co. v. Antonelli, Terry, Stout & Kraus LLP (VLW 010-3-620) on summary judgment, Alexandria U.S. District Judge Liam O'Grady looked to the allegations in the underlying legal malpractice complaint.

The defendants in the underlying action, filed in Florida, are patent attorney Donald E. Stout and his firm, Antonelli, Terry, Stout & Kraus LLP. The plaintiffs in the Florida suit, Ferguson v. Stout, are the estate of inventor Andrew A. Andros and some of the principal investors in the Telefind Corporation, formed by Andros in 1986 to market wireless messaging technology. Stout came on board in 1987, when Telefind retained him to perform patent prosecution services.

"Stout and his partners at the Antonelli Firm were impressed by Andros's business plan for Telefind, and they invested in the company," according to O'Grady's opinion.

How that wireless messaging technology wound up in the blockbuster BlackBerry devices, which fueled the rage for PDAs, is a tale for another day.

The story here picks up in 2006. That's when NTP Inc., a patent holding company formed in 1992 by Stout, software engineer Thomas J. Campana Jr. and Bill White, a representative of Telefind investors, settled a patent infringement case against the Canadian company Research in Motion, alleging patent infringement for RIM's use of the wireless e-mail transfer technology in RIM's BlackBerry system.

The RIM case settled for $612.5 million. The Andros estate and the Telefind investors say they never received any portion of the settlement. They sued in the Ferguson case, alleging breach of contract and breach of fiduciary duty.

The Antonelli firm turned to MLM, its carrier, who denied coverage and filed an action for declaratory judgment.

O'Grady said that barring any applicable exclusion, MLM had a duty to defend, as "the damages claimed by the Ferguson Plaintiffs result from Insureds' practice of law."

But he said Stout's activities as an investor in Telefind, NTP and a related company, Flatt Morris, triggered the policy's business enterprise exclusion and relieved MLM of its duty to defend.

The exclusion at issue exempted from coverage "any claim arising out of professional services rendered by an insured in connection with any business enterprise" owned, controlled or managed by any insured, where the claimed damages resulted from conflicts of interest with the interest of a client, former client or a person claiming an interest in the same or a related business enterprise.

There isn't a standardized "business exclusion" clause in malpractice policies, according to McLean lawyer Danny M. Howell, who represented MLM in the Antonelli case. Language varies in the clauses, and lawyers need to go back and look at their own policies.
Business exclusion clauses are common because they help malpractice carriers control and calculate their risk when a lawyer decides to pursue business opportunities that may lead to conflicts between the lawyers' personal interests and the client's interests.

Under the MLM policy, there were three elements to the test for the exclusion.

The malpractice claim must arise out of professional services rendered by the insured lawyers. In Antonelli, the claims in the malpractice suit arose "out of the legal advice rendered by Stout, so this condition is satisfied," O'Grady wrote.

Second, the lawyers must have rendered these services "in connection with" any enterprise the insured lawyers owned, controlled or managed.

Looking to cases from Massachusetts, North Carolina and Missouri, O'Grady said the claim must merely arise out of legal services rendered by the insureds that relate to such an enterprise. The court described Stout's legal strategy, as alleged in the malpractice complaint.

"The specifics of the legal strategy called on Campana and two colleagues ... to obtain patents for the Wireless Email Technology, and to assign those patents to a new company formed by Stout," O'Grady said. Then Stout and Campana, who had previously filed as co-owners of the Wireless Email Patents, transferred the patents into NTP.

"The legal strategy was unquestionably related to NTP as a business enterprise," the judge wrote.

In an alternative analysis, O'Grady found Stout's alleged scheme to protect Telefind's intellectual property also constituted a business enterprise.

"Stout's legal strategy called for the incorporation of a new business, and for coordinated action between Stout, Campana, the [Telefind] investors and Andros. It was at least nominally undertaken to improve the financial position of those holding an interest in the Wireless Email Patents. The scheme was, therefore, a business enterprise that relates to professional services provided by Stout," O'Grady wrote.

As a result of the alleged "scheme," Stout purportedly received $177 million, or roughly 30 percent of the total RIM settlement. The malpractice complaint alleged that Stout, as the "legal architect of the strategy," managed and controlled the larger enterprise - the scheme to transfer the Wireless Email Patents from Telefind to NTP.

Finally, the complaint met the third part of the test for the exclusion, because the plaintiffs' alleged damages arose from a conflict of interest.

"Stout's scheme to protect Wireless Email Technology for the benefit of the Ferguson Plaintiffs entailed his complete control over a client's asset. After obtaining a multi-million dollar verdict in the RIM litigation, Stout refused to share the largesse with the persons he had advised to grant him that complete control. Assuming the allegations are true, this is a clear case of conflict of interest that resulted in damage to the Ferguson Plaintiffs," O'Grady concluded.

The court entered summary judgment for MLM on Nov. 19.

There are a number of situations where lawyers have to stop and consider their role when advising business clients, Howell said.

A lawyer may decide to become a partner in a business and not realize that others are construing his comments as legal advice.

"There may be 10 partners, but you're the only lawyer in the room," Howell said. Later, you may be facing an allegation that there was an attorney-client relationship. "Lawyers have to be careful which hat they wear, and how they are perceived."

McLean lawyer Lon A. Berk represented Stout and the Antonelli firm. Berk could not be reached for comment.