

# FIRST CIRCUIT AFFIRMS COVERAGE FOR INVESTMENT MANAGER UNDER BUSINESS AND MANAGEMENT INDEMNITY POLICY

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## U.S. Insurance Coverage Alert

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The First Circuit Court of Appeals recently upheld a decision establishing coverage for a lawsuit filed by pension funds investors against an investment manager for allegedly mismanaging and squandering the pension funds' investments. *Scottsdale Insurance Co. v. Byrne*, -- F.3d -- ; 2019 WL 211420 (1st Cir. Jan. 16, 2019). The appellate court's decision is notable in that it made clear that Massachusetts law imposes a significant burden on an insurer to demonstrate that policy exclusions apply to bar coverage for claims that would otherwise be covered under a liability policy. It is also a decision that should be of interest to the investment management community because it suggests that many of the exclusions regularly relied upon by insurers to disclaim coverage for investment losses should be treated with a healthy dose of skepticism.

## BACKGROUND

In 2014, Timothy Byrne and Robert Bolt, acting as representatives of the Board of Trustees for the Plumbers and Pipefitters Local 51 Pension and Annuity Funds (the "Funds"), brought suit against Wellesley Advisory Realty Fund I, LLC ("WARF"), alleging that WARF had "mismanaged and squandered money" that the Funds had invested in that entity (the "Underlying Action"). *Id.* at \*1. In the Underlying Action, the Funds alleged that they invested \$5 million with WARF, which WARF subsequently used to invest in various real estate projects, including "The Stone House," a hotel in Little Compton, Rhode Island; a residential condominium in Newport, Rhode Island; and a housing development in North Attleboro, Massachusetts (collectively, the "Properties"). *Id.* at \*2. The Funds alleged that WARF entered into several mortgages to fund renovations of The Stone House, and that despite this debt, WARF retained all revenue from the hotel operations as a fee for managing the property, while failing to pay the required periodic mortgage payments. *Id.* Separately, the Funds alleged that WARF received notice from a different mortgagee of its intent to foreclose on and sell the North Attleboro property due to an unspecified breach of the conditions of that mortgage. *Id.* at \*3.

Based on these allegations, the Funds brought a claim alleging that WARF was negligent in overleveraging the Properties in excess of their value, failing to pay property taxes, and retaining income from the Properties for its own use. *Id.* In addition, the Funds brought an ERISA-based claim alleging that through its retention of revenues from The Stone House, WARF took on fiduciary duties to the Funds, which it subsequently violated through "self-dealing and mismanagement" of the Properties. *Id.*

WARF provided notice to its insurer, Scottsdale Insurance Company ("Scottsdale"), who denied coverage based on a number of exclusions contained within the Business and Management Indemnity Policy issued to WARF. [1]

As a result, WARF did not defend the Underlying Action and the district court entered a default judgment of \$5 million against WARF. *Id.* WARF thereafter assigned its rights to the Scottsdale policy to the Funds. *Id.* Scottsdale then brought a declaratory judgment action against the Funds in the United States District Court for the District of Massachusetts seeking a declaration that it did not owe WARF a duty to defend or indemnify under the policy and the Funds counterclaimed. *Id.*

On cross-motions for summary judgment, the district court ruled that the exclusions in the Scottsdale policy did not relieve Scottsdale of its duty to defend WARF and ultimately awarded the Funds \$3 million, the full limits of the Scottsdale policy, plus post-judgment interest. *Id.* On appeal, relying on the three different exclusions, Scottsdale argued that it did not breach its duty to defend under its policy and that even if it did, damages should be limited to the costs of defense. *Id.* at \*4.

## THE FIRST CIRCUIT AFFIRMS COVERAGE

The Scottsdale policy contained three different insuring clauses, the most pertinent of which provided:

The Insurer shall pay the Loss of the Company which the Company becomes legally obligated to pay by reason of a [Claim first] made against Company during the Policy Period ... and reported to the Insurer ... for any Wrongful Act taking place prior to the end of the Policy Period.

*Id.* at \*1. The policy defined "Claim" as a "civil proceeding against any insured seeking monetary damages or non-monetary or injunctive relief... ." *Id.* "Loss" was defined as "damages, judgments, settlements, pre-judgment or post-judgment interest awarded by a court." *Id.* "Wrongful Act" was defined as "any actual or alleged error, omission, misleading statement, misstatement, neglect, breach of duty or act allegedly committed or attempted by" the insured entities. *Id.*

Scottsdale did not contest that underlying claims triggered the insuring clause but rather attempted to deny coverage based on three exclusions. In a well-reasoned opinion, the First Circuit addressed each of the Scottsdale's arguments relying on these exclusions on appeal and ultimately affirmed the trial court's decision.

First, Scottsdale argued that all of the allegations in the case fell within a professional services exclusion contained in the policy, which provided:

Insurer is not liable for Loss ... on account of any Claim[ ] alleging, based upon, arising out of, attributable to, directly or indirectly resulting from, in consequence of, or in any way involving the rendering or failure to render Professional Services. Solely for the purposes of this exclusion, Professional Services means services as a real estate broker or agent, multiple listing agent, real estate appraiser, title agent, title abstractor or searcher, escrow agent, real estate developer, real estate consultant, property manager, real estate inspector, or construction manager. Such services shall include, without limitation, the purchase, sale, rental, leasing or valuation of real property; the arrangement of financing on real property; or any advice proffered by an Insured in connection with any of the foregoing.

*Id.* at \*2, \*5. The First Circuit rejected this argument, finding that while the allegations concerning management fees and redevelopment of The Stone House may have implicated the professional services exclusion, the more generalized allegations in the complaint relating to investments in the remaining two properties arguably did not and therefore there was a duty to defend those claims. *Id.*

The court further rejected Scottsdale's argument that all of the allegations fell within the broad definition of "Professional Services," which included the "arrangement of financing on real property." *Id.* The court reasoned that, in order for the exclusion to apply, the "services" at issue must have been provided by the policyholder acting as "a real estate broker or agent," "property manager," or another of the roles set forth in the policy, and held that it was unclear that WARF acted in such a role with respect to two of the properties. *Id.*

Second, Scottsdale argued that an ERISA exclusion barred both the negligence claim and the ERISA claim because the claims arose from the same set of facts. *Id.* at \*5-6. The ERISA exclusion at issue potentially applied to claims alleging "actual or alleged violations" of (1) ERISA; (2) "rules or regulations promulgated" pursuant to ERISA; or (3) "similar provisions of federal, state or local statutory or common law." *Id.* at \*6. The First Circuit rejected Scottsdale's defense based on this exclusion, reasoning that it was ambiguous as to whether the negligence claim, even if preempted under ERISA, amounted to claim based on a violation of a "similar provision[] of. . . state . . . common law." *Id.*

Last, Scottsdale argued that even if it had a duty to defend, it should have no obligation to pay for the default judgment based on the policy's conduct exclusion. *Id.* at \*6. The conduct exclusion potentially applied to claims arising out of or in any way involving "the gaining of any profit, remuneration or financial advantage" to which WARF was not legally entitled, but only in the event that there was a final judgment against WARF as to such conduct. *Id.* at \*1, \*6.

The First Circuit rejected this argument, noting that under Massachusetts law, if an insurer wrongfully fails to defend a claim, it is liable for all defense costs and the entire resulting judgment or settlement, unless it can meet its burden of proving that the claim was not within the policy's coverage. *Id.* at \*6 (citing, *inter alia*, *Metro Prop. & Cas. Ins. Co. v. Morrison*, 951 N.E.2d 662, 669 (Mass. 2011)). The court then went on to explain that self-dealing was just "one component" of the many allegations in the underlying action, which also included many allegations concerning WARF's squandering of the Funds' investment through overleveraging the Properties and failing to service pay taxes and mortgage payments. *Id.* In light of these allegations, the court held that Scottsdale did not meet its burden of demonstrating that the conduct exclusion covered all of the allegations in the complaint and similarly did not meet its burden of allocating the judgment award between WARF's improper gains and negligent losses. *Id.*

## THE IMPORTANCE OF THE DECISION

Although the First Circuit followed well-established Massachusetts insurance coverage law regarding the application of exclusions, the decision is notable in that it highlights how insurers will reflexively rely on exclusions to deny coverage. Importantly, the decision provides policyholders with at least three different lessons on how to successfully combat these attempts. First, the decision emphasized the insurers' burden of demonstrating that an exclusion applies to *all* potential liability as a matter of law in the duty to defend context. Where, as in this case, there are multiple claims and a series of different allegations that provide a basis for liability, insurers may face an uphill battle in meeting their burden of proving that an exclusion applies to bar coverage for the entire action.

Second, the First Circuit firmly rejected Scottsdale's attempt to rely on broad lead-in language (e.g., "arising out of" and "in any way involving") as a means to sweep all allegations within the ambit of an exclusion. The First Circuit made clear that even with broad lead-in language, an insurer would have to demonstrate that each of the specific allegations relating to a claim fell within the exclusion at issue. Again in circumstances involving various claims and allegations, an insurer may have difficulty disclaiming coverage based on exclusions even where those exclusions are preceded by broad lead-in language.

Last, the case demonstrates the perils of failing to provide an insured with a defense. In this case, Scottsdale's failure to defend resulted in a default judgment against WARF. By refusing to defend, Scottsdale lost the opportunity to contest liability. Scottsdale may have been able to limit its exposure had it simply defended the action and worked with WARF to resolve the claims. Instead, its failure to defend resulted in the assignment of policy rights to a claimant and liability for full policy limits.

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#### Note

[1] The policy named Wellesley Advisors Funds as the insured, and expressly added WARF as an insured "parent company" by way of endorsement. *Id.* at \*1, n.1. The complaint in the Underlying Action addressed allegations to both "Wellesley Advisors" and WARF interchangeably, but named only WARF as a party. The First Circuit and the parties did not address this issue and the First Circuit treated it as a "distinction without a difference." *Id.* at \*2, n.3.

## KEY CONTACTS



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