

Client Alert

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First Circuit Upholds Coverage for Massachusetts Investment Fund, Rejects Insurer's Misreading of Policy Exclusions

The First Circuit Court of Appeals recently affirmed a district court's ruling that three exclusions do not bar coverage under a management liability policy for a lawsuit filed by pension funds alleging that an investment firm "mismanaged and squandered money" the funds had invested. The appellate court in *Scottsdale Insurance Co. v. Bryne* upheld the \$3 million policy limits award plus post-judgment interest, holding that the insurer failed to meet its burden of proof that any of the three cited exclusions barred coverage for the entire lawsuit and, in doing so, misread its own policy, erred in not construing ambiguities in the policy in favor of the insured, and failed to account for all material claims and allegations in denying coverage.

Background

In 2014, representatives of the board of trustees of Plumbers and Pipefitters Local Pension and Annuity Funds filed a lawsuit against Wellesley Advisory Realty Fund alleging that WARF had mismanaged money the Funds had invested and was liable for negligence and ERISA violations. The Funds alleged that WARF had purchased three commercial and residential properties in Rhode Island and Massachusetts and that those investments had lost the Funds' entire \$5 million investment when the properties were either lost to foreclosure or written down to zero value because of taxes or mortgages owed.

WARF provided notice of the lawsuit to its insurer, Scottsdale Insurance Company, under a business and management liability policy, but Scottsdale denied coverage, citing multiple exclusions in the policy. The court entered a default judgment against WARF, and WARF subsequently assigned its rights under the Scottsdale policy to the Funds.

Scottsdale then brought a declaratory judgment action in Massachusetts federal court asking the court to rule that it did not have to provide defense or indemnity to WARF and, as a result, did not owe anything to the Funds following the assignment. The district court disagreed and held that the exclusions relied upon by Scottsdale to deny coverage did not apply. The court then awarded the Funds \$3 million, which was the full limits of the Scottsdale policy, plus post-judgment interest. Scottsdale appealed, arguing that it correctly denied coverage under the policy's professional services exclusion, ERISA exclusion, and conduct exclusion. The First Circuit found no basis to relieve Scottsdale of its obligation to pay the policy limit and affirmed the lower court's finding of coverage. The First Circuit's analysis under each exclusion and key takeaways from the Plumbers decision are below.

Professional Services Exclusion

First, Scottsdale argued that all allegations in the underlying lawsuit were excluded under the professional services exclusion, which barred coverage for claims arising out of the rendering of "services as a real estate broker or agent, multiple listing agent, real estate appraiser, title agent, title abstractor or searcher, escrow agent, real estate development, real estate consultant, property manager, real estate inspector, or construction manager." It contended that the Funds' allegations related to WARF's real estate

development, property management, and purchase of the properties at issue fell within the exclusion due to Massachusetts' broad reading of "arising out of" and "in any way involving."

The First Circuit rejected Scottsdale's argument, finding that it failed to account for all of the claims raised in the underlying lawsuit, which did not allege that WARF was developing, improving, or managing two of the three investment properties at issue. Because the lawsuit's "limited allegations" noted only that WARF had invested in those properties, the claims related to those properties were not clearly within the professional services exclusion and, where there is ambiguity, there is a duty to defend. The court also rejected Scottsdale's attempt to broaden the term "services" to include "arrangement of financing on real property," noting that Scottsdale "misreads its own policy" because the allegations "do not offer any meaningful basis" to conclude that WARF was acting in any of the enumerated roles set forth in the professional services exclusion with respect to two of the properties at issue in the lawsuit.

ERISA Exclusion

Second, Scottsdale argued that the Funds' lawsuit was not covered under an ERISA exclusion. That exclusion provides that Scottsdale is not liable for any actual or alleged violation of ERISA "or any rules or regulations promulgated thereunder, or similar provisions of any federal, state or local statutory or common law." Recognizing that the lawsuit contained both ERISA and *negligence* claims, Scottsdale asserted that even the negligence claims were excluded because they arose from the same set of facts as the ERISA violations.

The court rejected this argument because the exclusion does not apply to preempted state law claims and there is ambiguity as to whether the common law negligence claims "stated without reference to ERISA-like fiduciary duties" constitute a "similar provision" of "state common law" sufficient to trigger the exclusion. Thus, the court held there was no basis for excusing Scottsdale from its duty to defend based on the ERISA exclusion.

Conduct Exclusion

Finally, Scottsdale argued there was not coverage afforded to WARF due to the policy's conduct exclusion, which excluded coverage for claims arising out of the improper gaining of profit or financial advantage to which WARF was not legally entitled, but only where there was a "final judgment" against WARF as to such conduct. Although Scottsdale did not claim that the exclusion excused it from affording a defense, it nevertheless argued that even if it breached its duty to defend it should still be allowed to limit its indemnity obligations based on the lawsuit allegations about financial gains to which WARF was not entitled.

The court took Scottsdale to task for failing to satisfy its duty to defend, noting that where the insured defaults (as WARF did in the underlying litigation), the factual allegations as to liability are deemed admitted not only as to the insured and but also as to any insurers that wrongfully denied coverage. Insurers that improperly decline to defend a claim may still contest their indemnity, the court held, but the insurer bears the burden of proof to show that each claim fell outside the scope of coverage. Furthermore, where some claims fall within the policy's coverage and others do not, the insurer bears the burden of allocating a judgment between uncovered and covered claims.

Applying these principles in the WARF litigation, the First Circuit held that Scottsdale's attempt to limit its indemnity under the conduct exclusion failed for the same reason as the professional services exclusion—namely, its arguments failed to account for all claims made in the Funds' lawsuit, some of which did not involve allegations of "self-dealing" that potentially triggered the conduct exclusion. Self-dealing was "just one component of the many allegations" in the underlying complaint, and much of the complaint concerned squandering the Funds' investment that had nothing to do with improper gain or pecuniary advantage. Because those allegations were conclusively established by the default judgment

and offered a theory for liability that was “entirely separate from any improper gain by WARF,” Scottsdale had no basis to conclude that the conduct exclusion covers all of the material allegations in the lawsuit. Moreover, Scottsdale had failed to demonstrate any basis to allocate any portion of the default judgment award of \$3 million to noncovered claims.

Takeaways

The *Plumbers & Pipefitters Funds* decision shows that insurers continue to view policy exclusions liberally and construe allegations in their favor to trigger exclusionary language, even if there is no clear basis in the policy to do so. Insurer-friendly state law on trigger language (e.g., “arising out of,” “involving”) may favor broad interpretation of certain exclusions, but the coverage determination is still heavily dependent on whether the specific allegations in the lawsuit fall within the particular language used in each exclusion. This principle is especially important where, as was the case in the *Plumbers & Pipefitters Funds* decision, the lawsuit contains both covered and potentially excluded claims.

Policyholders should be aware of attempts to “shoehorn” otherwise covered claims into narrow exclusions, which as the First Circuit noted may amount to a misreading of the policy language without sufficiently accounting for the actual facts alleged. Thus, policyholders should not accept at face value the insurer’s characterizations of either the pertinent policy provisions or underlying facts and instead should carefully compare the actual allegations against the policy language to ensure that there is not even the potential for triggering defense obligations.

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