

*MDL Capital Management, Inc. v. Federal Insurance Company:*  
Third Circuit Decision Highlights Significance of  
Professional Services Exclusion in D&O Insurance Policy

May 29, 2008

**OVERVIEW**

In a recent opinion, the U.S. Court of Appeals for the Third Circuit broadly interpreted a professional services exclusion to bar coverage for claims against the directors of MDL Capital, an investment advisor and investment manager, arising out of the company's investment advice to the Ohio Workers Compensation Bureau (the "Ohio Bureau") and its management of a fund in which the Ohio Bureau had invested (the "Fund"). See *MDL Capital Mgmt., Inc. v. Federal Ins. Co.*, No. 06-4815, Slip Opinion, 2008 WL 876406 (3d Cir. Apr. 2, 2008). The Court found that because the Ohio Bureau's claims arose out of MDL Capital's "providing of, or failure to provide, professional services," the directors lacked coverage for *all* claims asserted in the Ohio Bureau complaint, even though some claims alleged breach of fiduciary duty, securities law violations, inaction, and lack of diligence by the directors in their role as directors of MDL Capital and the Fund.

Although *MDL Capital* is designated a "non-precedential opinion," its reasoning, if adopted by other courts, could prevent companies that provide investment advice and management services from recovering D&O coverage for claims against their directors where the claims allege director misconduct within the scope of the directors' duties. The opinion highlights the need to ensure that potential coverage gaps created by the professional services exclusion are bridged by errors and omissions coverage, i.e., coverage for claims by clients who allege errors in your work or the failure of your work to perform as promised in your contract.

**BACKGROUND**

In May 2005, Federal Insurance Company ("Federal") issued MDL Capital a binder (the "Binder") for commercial insurance coverage, including both directors and officers coverage (the "D&O Policy") and errors and omissions coverage (the "E&O Policy") with a combined limit of \$10 million. The D&O Policy contained a professional services exclusion, which barred coverage for:

Loss on account of any Claim based upon, arising from or in consequence of the rendering of or failure to render professional services, including but not limited to the following services:

- i. broker;
- ii. dealer;
- iii. financial adviser;
- iv. investment adviser;

- v. investment banker;
- vi. investment manager;
- vii. clearing agent;
- viii. trustee, fiduciary or agent within the Organization's Trust  
Department for individuals, governments, corporations or other  
entities.

*MDL Capital Management, Inc. v. Federal Ins. Co.*, No. 05cv1396, 06cv0389 (W.D. Pa., Oct. 16, 2006) 2006 WL 2974165, Slip Op. at \*4. The E&O Policy contained an endorsement entitled "Broad Private Fund Exclusion," although the text of the endorsement had not yet been provided in the Binder.

In June 2005, the Ohio Bureau brought claims of fraud, fraudulent inducement, negligent misrepresentation, breach of fiduciary duty, breach of contract, and securities law violations against MDL Capital, the Fund, and MDL Capital's individual directors (the "Director Defendants"), seeking damages for losses in the Fund. MDL Capital and certain of the Director Defendants subsequently commenced an action against Federal seeking a declaration of coverage for the Ohio Bureau's claims under the D&O Policy and E&O Policy, as per the Binder. Both parties moved for summary judgment.

#### THE DISTRICT COURT OPINION

The district court granted Federal's summary judgment motion, finding that coverage was barred by the professional services exclusion in the D&O Policy. Applying Pennsylvania law, the district court found that the Ohio Bureau's litigation arose from investment advice and fund management services provided by MDL, rendering *all* claims asserted in the litigation barred by the professional services exclusion:

There is no genuine issue of material fact that the allegations against plaintiffs in the [Ohio Bureau's] litigation are based upon, arise from, or are the consequence of rendering or failing to render investment adviser services, and therefore, this exclusion bars coverage under the D&O Policy.

*Id.* at \*8. The Director Defendants had argued for a narrower reading of the professional services exclusion, relying on an unreported District Court of Hawaii decision. *See Federal Insurance Company v. Hawaiian Electric Indus., Inc.*, No. 94-00125HG, 1997 U.S. Dist. LEXIS 24129, Slip Op. at \*32-\*34 (D. Hawaii December 23, 1997) (finding that "an expansive interpretation" of the professional services exclusion in a D&O policy "is not reasonable because it would have the effect of *vitiating virtually all of the coverage provided by a D&O policy*, the purpose of which is to cover any wrongful act committed by an officer or director in their capacity as an officer or director.") (emphasis added). The district court expressly refused to apply *Hawaiian Electric* in favor of a broad interpretation of the professional services exclusion.

In addition to holding that the D&O Policy barred coverage for the Ohio Bureau's litigation, the district court found that the E&O Policy provided no coverage based on the "Broad Private Fund

Exclusion,” notwithstanding the absence of any text. *MDL Capital*, No. 05cv1396, 06cv0389, 2006 WL 2974165, Slip Op. at \*8-\*9. As a result of these two rulings, MDL and its directors were left without coverage.

### THE THIRD CIRCUIT OPINION

On appeal, the Third Circuit reversed the district court’s ruling with respect to the E&O Policy, remanding the case for further proceedings to determine the scope of coverage under the E&O Policy.

The Third Circuit affirmed the ruling relating to the D&O Policy. Examining the Ohio Bureau’s complaint, the Third Circuit noted two roles allegedly played by MDL Capital – investment manager and investment advisor – each of which involved professional services as defined by the professional services exclusion in the D&O Policy. *MDL Capital*, No. 06-4815, 2008 WL 876406, Slip Op. at \*4. Accordingly, the Court found that the Ohio Bureau litigation “arises from the alleged provision of, or failure to provide, ‘professional service,’ and the [professional services exclusion] operates to withhold D&O coverage.” *Id.*

The Court acknowledged that the Ohio Bureau’s complaint also alleged wrongful conduct by the Director Defendants in their capacity as directors of MDL Capital. However, the Court rejected the argument that the distinction between MDL Capital’s provision of professional services and the Director Defendants’ conduct as directors warranted a narrower reading of the professional services exclusion, holding:

Plaintiffs attempt to avoid this [exclusion of coverage] by quoting a portion of the complaint that alleges, ‘inaction, lack of diligence and oversight, and failure to intervene by the Individual Director Defendants ... caused the overleveraging of [the Fund’s] assets.’ They assert that this language implicates them as directors of MDL Capital in a role that does not involve ‘professional services’ and hence would be covered under the D&O binder.

The complaint does assert that Lay, Sanders, and Adatepe were directors of both MDL Capital and [the Fund]. *Assuming the complaint states that they failed in their capacity as directors of MDL Capital to oversee its activities with respect to [the Fund], the allegation stems from MDL Capital’s purported failure as investment adviser and investment manager.* Consequently, the claim arises from the providing of, or failure to provide, professional services and D&O coverage is not available pursuant to the ‘Professional Services Exclusion-Complete.’

*Id.* (emphasis added). Essentially, the Third Circuit found that because the allegations asserted against the Director Defendants were rooted in MDL Capital’s role as investment advisor and

investment manager, all claims against the Director Defendants – even those unrelated to the provision of professional services – were excluded from coverage.

#### **CONCLUSION**

In the wake of *MDL Capital*, it would be prudent to assess whether your D&O policy contains a professional services exclusion and, if so, whether your E&O policy would provide coverage for any losses that may be barred by such an exclusion.

If you have any questions concerning the issues addressed in this memorandum, please contact Mary Beth Forshaw (mforshaw@stblaw.com/212-455-2846), Lynn Neuner (lneuner@stblaw.com/212-455-2696), or Elisa Alcabes (ealcabes@stblaw.com/212-455-3133).