

# Management Carveback in E&O Exclusion Applies to Customer Suit

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The United States District Court for the Southern District of New York, applying Maryland law, has held that an E&O exclusion containing a "Management Carveback" in a D&O policy issued to a company did not preclude coverage for a suit brought by a customer against the company and its officers and directors. *Seidel v. Houston Cas. Co.*, 2005 WL 646112 (S.D.N.Y. Mar. 7, 2005).

The insurer issued a D&O policy to an auction house. The policy stated that "[t]he insurer will pay to or on behalf of the Insured Persons Loss arising from Claims first made against them during the Policy Period or Discovery Period (if applicable) for Wrongful Acts." The policy included an "Errors and Omissions Exclusion (with Management Carveback)." The exclusion barred coverage for claims "in connection with the rendering of, or actual or alleged failure to render, any services for others for a fee or commission or on any other compensated basis by any person or entity otherwise entitled to coverage under this Policy." The management carveback stated that the exclusion "is not intended, however, nor shall it be construed, to apply to Loss, including Defense Costs, in connection with an Insured Person who is a director or officer of the Insured Organization to the extent that such Claim is for a Wrongful Act in connection with the management or supervision of any division, Subsidiary or group of the Insured Organization offering any of the aforementioned services."

A customer sued the auction house, its president, CFO and chairman, alleging that the auction house breached its contract to auction an inventory of antiques. The underlying plaintiff alleged that the individual defendants used funds due to customers pursuant to consignment contracts to cover operating expenses in a time of financial instability for the auction house.

The insurer initially provided a "preliminary coverage analysis" in which it stated that the defense costs sought by the insureds were not covered under the policy and reserved its rights. Notwithstanding this correspondence, counsel for the insureds continued to submit invoices for defense costs to the insurer, and the insurer approved defense counsel and reimbursed \$65,000 expended in defense of the underlying action. When counsel for the auction house submitted further invoices, however, the insurer denied coverage based on the E&O exclusion and refused to advance any additional amounts. The individual defendants then filed the instant action for breach of contract and sought a declaratory judgment as to the scope of coverage under the policy.

Applying Maryland law, the district court concluded that the allegations against the individual officers in the underlying complaint fell within the scope of the management carveback to the E&O exclusion and thus the policy "unambiguously" afforded coverage. In so holding, the court rejected the insurer's argument that the management carveback did not apply because the underlying action arose out of a transaction with the underlying plaintiff rather than any management or supervision of the auction house. The court reasoned that because "the root of [the customer's] dispute with [the auction house] was its auction contract with him does not alter the fact that [the customer's] suit directly challenged plaintiffs' management of [the auction house]" and that "[t]he only actions that [the customer's] suit questioned were plaintiffs' big-picture financial decisions about managing the company." Based on this analysis, the court concluded that the customer suit "clearly" constituted a claim for a wrongful act "in connection with the management or supervision of any division, Subsidiary or group of the" auction house.

The court also rejected the insurer's argument that the E&O exclusion was intended to exclude coverage for customer suits. The court explained that this "could be a plausible reading of the Policy as a whole *without the Management Carveback*," but that "the Carveback is necessary precisely because some customer claims are intended to be covered, specifically, those claims relating to management decision making." The court further held that "as a 'carveback' or exception to the customer service exclusion, [the management carveback] provides coverage for those management decisions that would otherwise arguably be within the exclusion for errors and omissions in connection with rendering services to clients." The court distinguished the underlying plaintiff's claims from a "claim against an auctioneer for shoddy service," reasoning that underlying plaintiff's claims "were directed at the highest level of the firm's management, and charged them with managing the company in a way that led not merely to a dereliction of service in a particular case, but to systematic malfeasance by the company."

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