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# Exclusions in Real Estate E&O Policy Foreclose Duty to Defend

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Applying Alabama law, a federal district court has rejected a real estate management company's claim that its insurer owes it a duty to defend underlying claims under a real estate errors and omissions policy. *Cont'l Cas. Co. v. HomeCorp Mgmt., Inc.*, 2012 WL 1067974 (M.D. Ala. Mar. 29, 2012). The court held that three separate exclusions barred coverage.

The underlying dispute arose out of a failed real estate investment. The insured real estate management company served as the property manager of the investment property. The investment property was purchased by a separate partnership indirectly owned by individual insureds working at the insured real estate management company. The insured persons each owned 17.5% of a limited liability company, which owned 92% of a second limited liability company, which in turn owned 50% of the partnership that purchased the real estate investment at issue. Other individuals who owned interests in the first limited liability company had signed guarantees in connection with the debt financing for the property, and they later sued the insured real estate management company and the insured persons alleging that they had been misled regarding the scope of the guarantees.

In the coverage litigation, the court held that three separate exclusions applied and barred coverage for the underlying lawsuit. First, the policy's financial interest exclusion barred coverage for any claim "arising out of the actual or attempted purchase of property by . . . any entity in which any Insured has a financial interest . . . provided that such financial interest existed at the time of the act or omission giving rise to the claim." The individual insureds argued that they did not have a financial interest in the partnership that actually

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purchased the subject partnership. Rejecting this argument, the court referred to dictionary definitions that defined "financial interest" to include having a monetary stake in an entity, and held that the individual insureds had such a stake in the success of the property. According to the court, if the property "did well, then by the terms of the operating agreements, a percentage of the profits would flow to [the partnership], then to [the second limited liability company], followed by [the first limit liability company] and its members, which includes the individual [insureds]." The court held that the individuals had a financial interest in the entity purchasing the property and that the financial interest exclusion thus applied.

Another exclusion provided that the insurer had no duty to defend "any claim . . . based on or arising out of the formation, syndication, operation or administration of any property syndication, real estate investment trust or any other form of corporation, general or limited partnership or joint venture formed for the purpose of investing in, buying, selling, or maintaining real property." The court held that this exclusion applied because the underlying claims arose out of the first limited liability company's financing and acquisition of the investment property.

A third exclusion provided that the insurer had no duty to defend "any claim . . . based on or arising out of the Insured's interests, operations, or activities as . . . [a] property developer." The court held that the exclusion applied because the insured persons formed the first LLC to develop real estate, used the LLC to purchase the investment property, and executed guarantees and persuaded others to execute guarantees to finance the project.

Accordingly, the court found that the insurer had no duty to defend the underlying claims.

The opinion is available here.