

“Professional Services” Exclusion Bars D&O Coverage for NASDAQ’s Mishandling of IPO

NASDAQ stock exchange faced significant exposure for its alleged mishandling of Facebook’s May 2012 initial public stock offering. NASDAQ’s E&O carriers footed the bill and invited NASDAQ’s D&O carriers to the event. The D&O carriers refused to be tagged in the picture, and coverage litigation ensued. The U.S. Court of Appeals for the Second Circuit recently resolved that litigation in favor of the D&O carriers, applying a “professional services” exclusion to bar coverage under the D&O policies. *Beazley Ins. Co., Inc. v. ACE Am. Ins. Co.*, 880 F.3d 64 (2d Cir. 2018).

NASDAQ is a public stock exchange that provides a platform on which its members execute securities transactions. NASDAQ handled the initial public offering (“IPO”) of Facebook, Inc. stock in May 2012, which went poorly due to technical failures on the platform. The technical failures resulted in the improper processing of orders to buy and sell Facebook stock. Retail investors sued, claiming losses due to the technical failure alleging that NASDAQ and two officers (its CEO and CIO) were liable for securities fraud and negligence. NASDAQ eventually settled the suit for \$26.5 million. NASDAQ and its officers submitted defense of the suit to its E&O and D&O carriers. The E&O carriers accepted coverage while the D&O carriers disclaimed coverage under the “professional services” exclusion.

The D&O policies provided coverage for losses “by reason of a Securities Claim . . . for any

Wrongful Acts.” They excluded coverage “for Loss on account of any Claim . . . by or on behalf of a customer or client of [NASDAQ], alleging, based upon, arising out of, or attributable to the rendering or failure to render professional services.” In subsequent coverage litigation that E&O carriers brought against D&O carriers, the U.S. District Court for the Southern District of New York enforced the professional services exclusion, precluding D&O coverage, because (1) retail investors were “customers” and (2) the underlying securities claims arose out of provision of professional services.

The Second Circuit affirmed. First, it agreed that the retail investors making up the putative class were a “customer or client” within the meaning of the professional services exclusion. The D&O policies did not define the terms “customer” or “client.” The District Court looked to federal case law and concluded that retail investors were “customers” of a stock exchange. The E&O carriers argued that referencing federal case law regarding securities litigation was inappropriate. The Second Circuit agreed with the District Court’s interpretation and noted that the D&O carriers “sold the policy to its insured, a stock exchange, against the backdrop of well-established federal securities law that unambiguously considers retail investors to be customers of the exchange.”

The Second Circuit also agreed that the retail investors’ suit against NASDAQ arose out of “professional services,” undefined by the D&O

policies, and the exclusion applied to preclude coverage. All parties conceded that the design and operation of the stock exchange's systems required the special acumen and training of a professional. While that concession precluded coverage for negligence claims, the E&O carriers argued coverage still existed under the D&O policies because the retail investors' securities claims were related to misstatements and omissions in an alleged aggressive marketing and commercial campaign to persuade Facebook to list its stock on the NASDAQ exchange.

To argue NASDAQ's self-promotion was not a professional service, the E&O carriers relied on *Rob Levine & Assocs. Ltd. v Travelers Cas. & Sur. Co. of Am.*, 944 F. Supp. 2d 288 (D.R.I. 2014); a suit finding no coverage for alleged dishonest promotion of a law firm as specializing in personal injury law because deceptive advertising was not a professional service – i.e., legal service. The Second Circuit distinguished *Rob Levine* and other similar cases, affirming application of the professional services exclusion. The securities fraud claim required loss causation: showing the deceptive conduct caused the claimed economic loss. The underlying action alleged this element by attributing losses to NASDAQ's failure to "properly execute" the purchase and sale order and deliver timely confirmation, not to marketing itself as the best exchange to handle Facebook's IPO. Accordingly, the Second Circuit affirmed that the professional services exclusion applied since the underlying action could not have proceeded without allegations that went "to the heart of NASDAQ's provisions of professional services."

Comment

The Second Circuit's decision applied a pragmatic lens to interpret undefined terms, but the

decision also turns on the case's unique facts. No doubt that the sophisticated nature of modern stock exchanges and the specific causes of action (negligence in trade execution and securities fraud related to a third party IPO) guided the Court's analysis of the "professional services" issue.

Interestingly, the closer call seemed to be whether the underlying retail investors were "customers" rather than whether the claim arose out of professional services. The same unique sophistication that rooted the underlying claim in professional services also fueled the counterargument that retail investors were not "customers" under the exclusion. Indeed, the insured focused on its role in providing an electronic trading platform to execute securities transactions by matching buy and sell orders and providing confirmations. That gave the E&O carriers an invitation to argue that NASDAQ provided those professional services only to the official members of its exchange – the broker-dealers who placed the trades.

In the end, the D&O carriers were able to rely on a highly specialized body of federal law to convince the Court that the retail investors were still exchange "customers" despite not being members of the exchange or directly involved in the transactions on the exchange. As the Court observed, though, "securities law is 'paradigmatically a federal field.'" Thus, the D&O carriers were able to point to federal case law and avoid any ambiguity that may have come from other sources. Other less uniquely federally regulated industries would perhaps be better served by referencing state law or industry parlance to shed light on the parties' mutual understanding of an undefined term. Moreover, the fact securities fraud cases require specific and

technical pleading of loss and causation elements potentially narrows what may seem like a broad ranging application of the professional services exclusion.

If you have any questions about this Update, please contact the author listed below or the

Aronberg Goldgehn attorney with whom you normally consult:

Mark A. Swantek
mswantek@agdglaw.com
312.755.3141

Christopher J. Bannon • 312.755.3175 • cbannon@agdglaw.com
Lisa J. Brodsky • 312.755.3177 • lbrodsky@agdglaw.com
Thomas K. Hanekamp • 312.755.3160 • thanekamp@agdglaw.com
Amber O. LaFevers • 312.755.3170 • alafevers@agdglaw.com
Catherine Warren • 312.755.3157 • cwarren@agdglaw.com
Daniel J. Berkowitz • 312.755.3167 • dberkowitz@agdglaw.com
Lindsay P. Lollo • 312.755.3171 • llollo@agdglaw.com
Danielle L. Rosenberg • 312.755.3172 • drosenberg@agdglaw.com
Mark A. Swantek • 312.755.3141 • mswantek@agdglaw.com