Coverage Battle At 9th Circ. May Hobble Private D&O Policies

Law360

Scottsdale Insurance Co. recently asked the Ninth Circuit to uphold a ruling that an exclusion in an education technology company's policy for claims related to professional services bars coverage for a False Claims Act suit, and attorneys say a decision in the insurer's favor could severely limit D&O coverage for privately held service providers.

In an appellate brief filed Wednesday, Scottsdale said U.S. District Judge Claudia Wilken properly concluded in a November decision that the professional services exclusion in HotChalk Inc.'s directors and officers policy precludes coverage for the company's costs to defend and settle the underlying FCA action. Crucially, the judge found that allegations that HotChalk had provided improper incentives to employees related directly to the company's services to universities.

HotChalk is contending on appeal that Judge Wilken failed to differentiate between the company's services to its clients and its in-house practices. Under the judge's interpretation, HotChalk has said, the professional services exclusion would foreclose coverage for almost any claim against the company.

Farella Braun & Martel LLP partner Tyler Gerking, who is representing policyholder advocacy group United Policyholders as an amicus in support of HotChalk, said the case represents a trend of insurers aggressively asserting professional services exclusions, which are also known as contractual liability exclusions. For privately held companies that provide information technology or other services to clients, a broad interpretation of those exclusions could effectively erase coverage for any claim against the company's directors and officers, attorneys say.

"It is not uncommon to see D&O insurers assert that the contractual liability exclusion bars coverage for private company service providers, in a manner that would arguably eliminate all coverage offered to those companies," Gerking said.

But Hinshaw & Culbertson LLP partner Larry Golub, who represents insurers, pointed out that HotChalk had already secured coverage for the FCA litigation under a separate employment practices liability policy with underwriters at Lloyd's of London. So Judge Wilken's decision didn't entirely deprive HotChalk of coverage, he said.

"Oftentimes, an exclusion in one policy is an invitation to obtain coverage under another policy," Golub said. "Generally, different types of policies shouldn't overlap, and HotChalk seems to be attempting to secure coverage under multiple policies."

Campbell, California-based HotChalk helps universities create or expand online degree programs by providing promotional and administrative services, including recruiting students.

In April 2014, former HotChalk employees filed an FCA complaint accusing the company of falsely certifying to the U.S. Department of Education that it complied with Title IV of the Higher Education Act of 1965, while providing prohibited incentive payments to employees charged with recruiting students.

Scottsdale denied HotChalk's request for a defense, saying the FCA claims fell under the policy's professional services exclusion, which bars coverage for claims "alleging, based upon, arising out of, attributable to, directly or indirectly resulting from, in consequence of, or in any way involving" the policyholder's professional services. HotChalk, which racked up $986,000 in defense costs, later settled the case for a total of just under $1 million, then sued Scottsdale for refusing coverage.

Last November, Judge Wilken agreed with the insurer that the professional services exclusion applies to preclude coverage, saying HotChalk's incentive-based compensation scheme was only alleged to be improper because of the professional services that the company provided to its clients.

HotChalk has told the Ninth Circuit that Judge Wilken's interpretation of the exclusion would envelop all of its activities, rendering the Scottsdale policy "virtually worthless." Scottsdale, meanwhile, has countered that the district judge's ruling was proper because there was a direct relationship between HotChalk's purported violations of the incentive compensation ban and the alleged injury to the federal government.

In its amicus brief, United Policyholders said that D&O policies issued to private companies are designed to cover a "far broader array" of claims than such policies issued to publicly traded companies.

Therefore, expansive interpretations of the professional services exclusion such as that adopted by Judge Wilken could eviscerate that coverage, the group argued.

“If the test is that the claims somehow arise from or relate to the services the private company provides, then if the company is in the business of providing services, insurers may say management decisions relate in some way to those services,” Gerking, United Policyholders’ counsel, elaborated to Law360. “That really interferes with the policyholders’ reasonable expectations of coverage.”

Orrick Herrington & Sutcliffe LLP partner Darren S. Teshima, who represents policyholders, also asserted that Judge Wilken’s reading of the exclusion would eliminate bargained-for coverage.

“Presumably, the insurer knew this company provided technology services when it issued the policy, so to interpret the exclusion to extend to anything related to that business would render the policy illusory,” Teshima said.

However, attorneys who represent insurance carriers said that under Judge Wilken’s decision, HotChalk could still be covered under the Scottsdale policy for certain claims, such as claims attacking directors and officers’ business decisions.

“‘Illusory’ is in the eye of the beholder,” said Golub. “That argument essentially means nothing would be covered. Here, this argument does not fly since the policy would cover more typical D&O types of claims.”

Zelle LLP partner Rina Carmel noted that California courts have long interpreted the “arising out of” language appearing in the professional services exclusion to have a broad meaning.

“All of this descriptive causal language, if it gets interpreted broadly in coverage provisions, it should have the same definition in an exclusion,” Carmel said. “The California courts have clearly spoken to that, so the Ninth Circuit should follow existing California cases rather than looking to the out-of-state federal decisions cited by HotChalk.”

As Kilpatrick Townsend & Stockton LLP counsel William T. Um sees it, though, the “arising out of” analysis must be “more particularized” and focused on the specific allegations against the policyholder, which he said was not the case in Judge Wilken’s decision. Um said he wouldn’t be surprised if the Ninth Circuit

reversed the lower court.

“This is one of those situations where there was an overreach by the carriers, and as a result I expect that the pendulum is going to swing the other way,” Um said. “It’s a ‘bad facts make bad law’ type of situation — the breadth of this exclusion has been pressed just a bit too far.”

HotChalk is represented by Peter Roldan and Christopher Wimmer of Emergent LLP.

Scottsdale is represented by Alexis Rogoski and Jonathan Andrew Sorkowitz of Skarzynski Black LLC and Hee Young Lee of Herman & Lee LLP.

United Policyholders is represented in-house by Amy R. Bach and Daniel R. Wade and by Tyler Gerking and Deborah K. Barron of Farella Braun & Martel LLP.

The case is HotChalk Inc. v. Scottsdale Insurance Co., case number 16-17287, in the U.S. Court of Appeals for the Ninth Circuit.

–Editing by Philip Shea and Brian Baresch.
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