

Testing Professional Services Exclusions To FCA Allegations

By Jan Larson and Jennifer Senior

Law360, New York (June 7, 2017, 4:48 PM EDT) -- An appeal pending before the U.S. Court of Appeals for the Ninth Circuit in the case of HotChalk Inc. v. Scottsdale Insurance Co. is likely to shape the scope of professional services exclusions and determine whether they are so broad as to sweep in the types of allegations often brought against companies under the False Claims Act in connection with a company's interactions with the government or various government programs. Specifically, the Ninth Circuit's decision is expected to address the availability of coverage for claims relating to a policyholder's internal activities, such as compensation practices, that are arguably ancillary to the policyholder's external business practices or professional services provided to its clients and customers.



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In a much discussed appeal pending before the U.S. Court of Appeals for the Ninth Circuit in the case of HotChalk Inc. v. Scottsdale Insurance Co., the parties dispute the application of a professional services exclusion to False Claims Act allegations, and specifically, whether a distinction may be drawn between those allegations as they relate to internal business practices, as opposed to external professional services provided to clients and customers.



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The underlying action alleges that HotChalk Inc. (HotChalk), which provides services in connection with online degree programs for client universities, violated the False Claims Act to the extent it paid employees incentive compensation tied to success in recruiting students for its client universities' online degree programs. In more detail, HotChalk's business relates to the creation or expansion of online degree programs for universities. HotChalk's services include providing technology, promotion and administrative support for those programs, including by recruiting students.

In the underlying action, HotChalk's former employees filed a qui tam complaint alleging that HotChalk and its client universities violated the False Claims Act, by falsely certifying to the U.S. Department of Education that it complied with Title IV of the Higher Education Act of 1965. The Higher Education Act of 1965 prohibits any institution that participates in grant and loan programs under the Act from paying

employees charged with admissions or financial aid any commission, bonus or incentive payments based directly or indirectly on success in securing enrollments or financial aid. The plaintiffs alleged that HotChalk is subject to the act's requirements, and violated them by paying numerous forms of incentive payments to employees charged with recruiting students. HotChalk ultimately settled the underlying action, resulting in a payment to the United States and a separate payment to the plaintiffs for their attorneys' fees only.

HotChalk sought a defense and indemnity under the directors and officers (D&O) insurance policy it had purchased from its insurer, Scottsdale Insurance Co. (Scottsdale). HotChalk had incurred \$986,000 in defense costs in connection with the underlying action, as well as an additional nearly \$1 million in settlement contributions. The insurance dispute between HotChalk and Scottsdale that is now before the Ninth Circuit arises from Scottsdale's denial of coverage pursuant to a policy exclusion for losses arising out of HotChalk's "professional services" — specifically, to loss "on account of any Claim alleging, based upon, arising out of, attributable to, directly or indirectly arising from, in consequence of, or in any way involving the rendering or failing to render professional services."

The U.S. District Court for the Northern District of California agreed with Scottsdale that the policy's professional services exclusion bars coverage for HotChalk's claim. The district court reasoned that terms such as "arising out of" and "in any way involving," as they appear in the professional services exclusion, have been broadly interpreted. Consistent with a broad interpretation of those exclusionary terms, the district court found that HotChalk's allegedly incentive-based compensation scheme had a "causal link" with HotChalk's professional services because it could only have been improper as a result of the professional services that HotChalk provided to its client universities. The district court further noted that HotChalk specifically agreed, as part of its service agreement with one client university, to comply with the incentive compensation ban. As a result, the district court rejected HotChalk's contention that the lawsuit related only to its internal policies for compensating employees, and not to the professional services provided externally to its client universities.

On appeal before the Ninth Circuit, HotChalk contends that the district court's interpretation of the professional services exclusion is overly broad and inconsistent with California law. Specifically, HotChalk asserts that California law, like many other jurisdictions, requires a narrow interpretation of policy exclusions, including a narrow application of terms such as "arising out of" and "in any way involved" as they appear in the professional services exclusion. Accordingly, HotChalk argues that the district court erred in rejecting the distinction HotChalk drew between external services provided to its client universities, and ancillary activities provided internally, such as internal compensation practices. Additionally, HotChalk contends that the district court should have focused on whether the underlying action arose from any specialized knowledge, labor or skill being provided as a professional service — which it did not — to determine whether it fell within the scope of the professional services exclusion. To interpret the professional services exclusion as the district court did, envelops all of HotChalk's activities and effectively nullifies the coverage purchased and renders it "virtually worthless," according to HotChalk.

An amicus brief filed in support of HotChalk by United Policyholders agrees, arguing that expansive

interpretations of the professional services exclusion risk rendering policyholders' reasonable expectations of coverage illusory. United Policyholders claims this is particularly true in the context of a professional services exclusion as it appears in a D&O policy issued to a private company, like HotChalk, as opposed to a public company because such coverage for private companies is designed to cover a "far broader array" of claims than for public companies.

In response, Scottsdale contends that the plain language of the professional services exclusion, as drafted, requires only a "minimal causal connection or incidental relationship" between the services of the policyholder and the alleged wrongful actions. Scottsdale argues on appeal that the underlying False Claims Act allegations against HotChalk relate directly to HotChalk's performance of recruitment services for its client universities, and thus, HotChalk's professional services.

The pending appeal in *HotChalk Inc. v. Scottsdale Insurance Co.* has generated a fair amount of discussion in insurance circles. The Ninth Circuit's decision is expected to have significant implications in framing the scope of professional services exclusions as applied generally, and in particular, to the types of allegations often faced by companies under the False Claims Act in connection with a company's interactions with the government or various government programs. Policyholders advocate for the Ninth Circuit to narrowly interpret the professional services exclusion consistent with the exclusion's status as a provision intended to limit coverage and to recognize the distinction between a policyholder's internal business practices, as opposed to external professional services provided to clients and customers.

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