THIS YEAR'S SUMMER INSURANCE BLOCKBUSTER:

05

OFFICE DEPOT V. AIG SPECIALTY INSURANCE COMPANY

Starring the Contractual Liability, Prior Acts and Regulatory Exclusions

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Action movies aren't the only hits coming out of Hollywood this Summer. *In Office Depot, Inc. v. AIG Specialty Insurance Company*, Case No. 15-cv-2416 (C.D. Cal. Jun. 21, 2019), the United States District Court for the Central District of California issued a "must-see" opinion finding that – not one, not two, but – three liability policy exclusions separately and independently barred coverage for a *qui tam* lawsuit. While the case is pending an appeal to the Ninth Circuit,[1] the decision is important for several reasons. First, the decision underscores the principle that broadly worded exclusions should be applied broadly. Second, the decision provides an instructive "but for" test in applying the contractual liability exclusion carve-back for "liability or obligation an Insured would have in the absence of such contract or agreement." Finally, the decision confirms that *qui tam* lawsuits are in fact brought "by or on behalf" of a government agency, and that the plain language of regulatory exclusions will generally be upheld.

Claim Background: The *Sherwin* Action

In March 2009, a *qui tam* relator and former Office Depot employee filed a complaint under seal against Office Depot.[2] The Sherwin Action was brought on behalf of over 1,000 California state and local government entities, including over 60 school districts and regional agencies, which were allegedly overcharged by Office Depot through a variety of underhanded pricing practices.

The *Sherwin* Action involved a supply contract between Office Depot and the U.S. Communities Government Purchasing Alliance (the "USC Contract"), a non-profit that maintains procurement contracts for the purchase of goods and services by state and local public entities. From 1996 to 2010, the USC Contract was negotiated and managed by lead public entity Los Angeles County, and adopted and subscribed to by numerous other California counties, cities, school districts and regional agencies through an administrative agreement between U.S. Communities and Office Depot. At the time of the *Sherwin* Action, the USC Contract was Office Depot's single largest contract.

It was Office Depot's alleged fraudulent conduct in overcharging the government entities who opted into the USC Contract that was at the heart of the *Sherwin* Action. Specifically, it was alleged that Office Depot engaged in an overcharging scheme that involved: (1) falsely promising in marketing materials that the plaintiffs would receive the best pricing available to any government entity through provisions in the USC Contract; (2) causing the plaintiffs to switch to higher pricing structures and using its catalogues and website to disguise the increased charges resulting from the switch; (3) misrepresenting costs by excluding manufacturer rebates, so it could charge more under the USC Contract for non-core items; (4) changing its prices frequently and without disclosure, despite its commitment under the USC Contract to increase prices only twice per year; and (5) discontinuing products on its core list so it could charge more for a comparable item on the non-core list, or for a private-label item.

The operative complaint in the *Sherwin* Action contained a single cause of action against Office Depot for violation of the California False Claims Act for "knowingly present[ing] . . . false and fraudulent claims, and knowingly fail[ing] to disclose material facts, in order to obtain payment and approval" from the plaintiff government entities. Similarly, an additional 19 California political subdivision intervenors asserted common-law fraud and breach of contract in addition to their own False Claims Act allegations.

Following mediation in 2014, Office Depot settled the *Sherwin* Action by agreeing to pay $77.5 million, consisting of $68.5 million in damages and $9 million in attorneys' fees. The *Sherwin* Action was settled and dismissed before any factual determinations were made, and without any admission of liability by Office Depot.

The *Office Depot* Coverage Action

After the *qui tam* complaint was unsealed and served on Office Depot in 2012, Office Depot tendered the complaint for defense and indemnity coverage under two consecutive media liability insurance policies issued by AIG. AIG denied coverage on several grounds, including a Contractual Liability Exclusion, the Prior Acts Exclusion, and the Regulatory Exclusion. Office Depot then filed a complaint for declaratory judgment and breach of contract action against AIG.[3] The parties filed cross-motions for partial summary judgment on AIG's duty to defend and indemnify.

On June 21, 2019, the district court issued an opinion holding that AIG had no duty to defend or indemnify Office Depot. As an initial matter, the court addressed whether the *Sherwin* Action even triggered the insuring agreements of the AIG policies. The policies provided that AIG would provide coverage for Office Depot's wrongful acts as long as the wrongful acts first occurred during the policy period. Therefore, the threshold issue was whether Office Depot's wrongful acts first occurred during the policy periods of March 8, 2007 through March 8, 2008 or March 8, 2008 through March 8, 2009. Because the *Sherwin* Action sought damages for sales transactions over a ten-year period starting in 2001 and continuing through 2011, the court concluded that the wrongful acts alleged did not *first* take place during the relevant policy periods. Accordingly, the court held that the *Sherwin* Action did not trigger the AIG policies.

The court could have stopped there—but it didn't. The court further held that, even if the *Sherwin* Action

triggered the insuring agreement, coverage was separately and independently barred by the Contractual Liability Exclusion, the Prior Acts Exclusion, and the Regulatory Exclusion.

1. The Contractual Liability Exclusion

The Contractual Liability Exclusion excluded coverage for any claim "alleging, arising out of or resulting, directly or indirectly, from any liability or obligation under contract or agreement or out of any breach of contract."

AIG argued that coverage for the *Sherwin* Action was precluded in its entirety by the Contractual Liability Exclusion because the *Sherwin* Action "arises out of" Office Depot's contractual obligations under the USC Contract, notwithstanding the non-breach of contract causes of action. AIG pointed to the fact that the operative complaint was replete with contract-based allegations, and that Office Depot itself had confirmed the contractual nature of the case in testimony and filings during the *Sherwin* Action. In describing the gravamen of the *Sherwin* Action, Office Depot's in-house counsel had testified that "this is a complaint for violation of the False Claims Act, but the claims and allegations that he made were related to our performance or nonperformance of our government contracts."

Office Depot argued that the Contractual Liability Exclusion did not apply because it contained a carve-back for "liability or obligation [Office Depot] would have had in the absence of such contract or agreement." Office Depot argued that this carve-back meant that the Contractual Liability Exclusion does not apply because the *Sherwin* Action contained tort-based causes of action for violations of the False Claims Act and common law fraud.

The court agreed with AIG. Typically, courts grapple with the difference between narrow "for" exclusions and broad "arising out of" exclusions. Here, the court went one step further, noting that the exclusion in the AIG Policy was even broader than a typical "arising out of" exclusion:

> [T]he exclusion here is much broader than a typical "breach of contract" exclusion; it excludes not only claims arising out of a breach of contract but also claims alleging, arising out of, or resulting, even indirectly, from any liability or obligation under any contract or agreement. The distinction is crucial because the additional breadth excludes claims that are not strictly contractual.

Second, the court analyzed the exclusion's carve-back for "liability or obligation an Insured would have in the absence of such contract or agreement" under a "but for" test. Specifically, the court determined that the False Claims Act and common-law claims would have not existed but for the USC Contract:

> Even if CFCA and fraud claims are not breach-of-contract legal theories, under the factual allegations of the *Sherwin* Lawsuit the allegedly wrongful conduct would not have existed without the Master Agreements and U.S. Communities Contract. Thus, even if the exclusion were limited to claims arising out of a breach of contract . . . the exclusion would still bar coverage of the wrongful acts alleged in the *Sherwin* Lawsuit.

Therefore, the court concluded: "On its face, this exclusion applies; under any reasonable interpretation of the exclusionary language, the *Sherwin* [Action] alleged, arose out of, or resulted, indirectly (if not directly), from Office Depot's obligations under the [USC Contract]."

2. The Prior Acts Exclusion

The Prior Acts Exclusion excluded coverage for any claim "alleging, arising out of or resulting, directly or indirectly, from any wrongful act, related wrongful act or series of continuous or repeated wrongful acts where the first such wrongful act first occurs prior to the inception of or subsequent to the termination of the policy period." First, the court reaffirmed the broad nature of the "arising out of" language in the Prior Acts Exclusion:

> [The Prior Acts Exclusion] bars coverage of claims *alleging, arising out of, or resulting, even indirectly*, from any wrongful act, *related wrongful* acts, or *series of continuous or repeated wrongful acts* where the first wrongful act occurs prior to the inception of the policy period. This language makes clear that the exclusion groups all "related" or "series of" wrongful acts. If the first of many related wrongful acts occurred prior to the inception of the policy period, all such related acts are excluded from coverage [emphasis court's].

Next, the court related all of Office Depot's alleged wrongful acts as set forth in the *Sherwin* Action. Therefore, the Office

Depot decision can be cited in other cases involving broad exclusionary language and wrongful acts occurring both before and after the relevant prior acts date. In these cases, as supported by the rationale in Office Depot, even if there are wrongful acts occurring after the relevant prior acts date, coverage for the entire complaint may still be excluded because: (1) the exclusion applies to the entire "Claim" (i.e., the complaint or civil proceeding), and/or (2) the prior acts exclusion contains broad aggregation language excluding coverage not just for the prior acts themselves, but any related acts.

3. The Regulatory Exclusion

The Regulatory Exclusion excluded coverage for any claim "that is brought by or on behalf of the Federal Trade Commission, the Department of Health and Human Services, the Office of Civil Rights, the Federal Communications Commission, or any other federal, state or local government agency, or foreign government agency."

AIG argued that, by definition, a *qui tam* lawsuit under the California False Claims Act like the *Sherwin* Action falls within the Regulatory Exclusion because they are brought by or on behalf of government agencies. In this regard, the relevant California statutory *qui tam* provision provides that a *qui tam* plaintiff brings his or her action either for the State of California itself or for a "political subdivision." Under the statute, a "political subdivision" is expressly listed as a type of "local government agency."

Office Depot argued that the statutory definitions were irrelevant, and that the phrase "federal, state or local government agency" as used in the Regulatory Exclusion should be read in the context of the specific agencies listed and therefore is meant to refer only to an agency bringing an administrative or regulatory proceeding or claim.

The court agreed with AIG, and held that the Regulatory Exclusion also barred coverage for the *Sherwin* Action because a *qui tam* lawsuit is brought "by or on behalf of" a government agency. In doing so, the court upheld the plain language of the exclusion and enforced the policy language as written. Even though the State of California was not specifically listed in the exclusion, the Regulatory Exclusion included "any other federal, state or local government agency, or foreign government agency." [4]

Looking Ahead

As noted above, Office Depot has appealed the district court's decision to the Ninth Circuit. Notably, the Ninth Circuit issued an opinion just last year in *HotChalk, Inc. v. Scottsdale Insurance Co.,* 736 Fed.Appx. 646 (9th Cir. Jun. 4. 2018) confirming the broad scope of the "arising out of" policy language in the context of a professional services exclusion. The *Office Depot* decision is just one example among a growing trend of recent case law in which courts, in the first half of 2019 alone, have consistently upheld the broad "based upon, arising out of …" language. See, e.g., *UBS Financial Servs. Inc. v. XL Specialty Ins. Co.,* No. 18-1148 (1st Cir. July 3, 2019) (Specific Litigation Exclusion); *Biochemics, Inc. v. Axis Reinsurance Co.,* 2019 WL 2223125 (1st Cir. May 23, 2019) (Interrelated Wrongful Acts); *Colorado Boxed Beef Co., Inc. v. Evanston Ins. Co.,* No. 19-10326, 2019 WL 2479321 (11th Cir. June 13, 2019) (Securities Exclusion); *Ocean Towers Hous. Corp. v. Evanston Ins. Co.,* 2019 WL 2484415 (9th Cir. June 14, 2019) (Specific Matter Exclusion); *Tile Shop Holdings, Inc. v. Allied World Nat'l Assurance Co.,* 2019 WL 2357044 (D. Minn. June 4, 2019) (Prior Acts Exclusion).

While sequels hardly ever live up to the original, there are always exceptions *(The Godfather Part II, Terminator 2)*. So, while the Ninth Circuit's opinion could be a brief three-page opinion, it's also possible that the Ninth Circuit's decision will include a robust discussion of the broad preamble language, the carve-back to the Contractual Liability Exclusion, and the aggregation language in the Prior Acts Exclusion. That alone would be worth the price of admission. Stay tuned . . .

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End Notes

[1] Office Depot's opening brief is currently due October 25, 2019.

[2] State of California et al., ex rel. David Sherwin v. Office Depot, Inc., Case No. BC410135 (Superior Court, Los Angeles County) (the "Sherwin Action").

[3] Office Depot, Inc. v. AIG Specialty Insurance Company, Case No. 15-cv-2416 (C.D. Cal.).

[4] The court also held that "Because [AIG] is entitled to summary judgment as to the duty to defend, [AIG] is also entitled to summary judgment as to indemnity." Philadelphia Indem. Ins. Co. v. Hollycal Prod., Inc., No. ED CV 18-768 PA (SPx), 2018 WL 6520412, at *5 (C.D. Cal. Dec. 7, 2018).