



Surviving False Claims Act Allegations:

What Every Government Contractor Needs to Know to Maximize Insurance Coverage



A discussion of specific “Directors and Officers Liability” policy provisions that should be of particular concern to government contractors when purchasing their policies and in determining the extent to which they are covered against FCA claims.

BY STEPHEN T. RAPTIS



In recent years, an increasing number of governmental and private party “whistleblower” claims alleging fraudulent claims for payment from the U.S. federal government have been brought against government contractors under the federal False Claims Act (FCA).!

Civil violations of the FCA carry severe economic consequences, potentially including treble damages, additional civil penalties, and payment of the government's costs in pursuing the FCA case.² Moreover, the legal costs of defending the company (and, in some cases, its officers or directors) from investigations and related actions under the FCA can be staggering, often reaching hundreds of thousands, if not millions, of dollars. It is therefore critical for companies that do business with the government to consider purchasing appropriate insurance coverage, and, if claims arise, carefully preserve and pursue coverage claims.

Of the various types of insurance purchased by most companies, "Directors and Officers Liability" (D&O) policies are the most likely to cover alleged FCA violations. D&O policies typically insure against losses involving "Claims" arising from "Wrongful Acts," as defined in the policy, committed by the company's officers and directors. *Wrongful Acts* are typically defined to include some combination of "errors," "misleading statements," "acts," "omissions," "neglect," and "breaches of duties" committed by an insured. The company can also elect to purchase optional "entity" or "Side C" coverage, which protects the company itself against losses arising from Wrongful Acts. Because most FCA actions involve at least some claims directed at the company, purchasing entity coverage is the most critical step the company can take to protect itself against the substantial expense associated with FCA claims. Accordingly, government contractors should give serious consideration to purchasing entity coverage, despite its additional cost.³ Note, however, that for publicly traded and large private companies, the scope of available entity coverage may be considerably less broad than for other companies, and often is limited to securities-related claims.

Because language among D&O policies varies in critical respects, it is imperative that a government contractor understand the protections and limitations of the coverage it has purchased or is considering purchasing before an FCA claim arises and, where warranted, negotiate for more suitable policy language. This article discusses specific D&O policy provisions that should be of particular concern to government contractors when purchasing their D&O policies and in determining the extent to which they are covered against FCA claims.⁴

Potentially Problematic Exclusions

Certain exclusions have become standard in D&O policies, and therefore may be overlooked by government contractors when purchasing D&O coverage. However, these exclusions can have profound and often unanticipated consequences in the context of FCA claims.

Contractual Liability Exclusion

Most D&O policies contain broadly worded exclusions for losses arising from liability of the insured under any written or verbal contract or agreement (except to the extent that the insured would bear such liability absent the contract). On its face, the intent of this exclusion



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appears to be relatively narrow—to limit the insurer’s exposure for liability voluntarily assumed by its insured (e.g., through indemnity agreements) that the insurer never intended to underwrite. However, insurers have argued, with mixed results, that the exclusion applies more broadly to preclude coverage for claims involving Wrongful Acts that relate to a contract in any way.⁵

Such a broad interpretation threatens to preclude coverage for government contractors because the fundamental nature of the contractor’s relationship with the government is based on a contract. Insurers may assert, therefore, that FCA claims are not covered because they arise from or relate to contracts with the government. Although contractors have strong arguments in response,⁶ the contractor could avoid this fight and its associated coverage risks altogether by negotiating to narrow the exclusion.

Fraud Exclusion

Culpability under the FCA requires a “knowing” presentation of a “false or fraudulent claim for payment or approval.” *Knowing* includes “deliberate ignorance” and “reckless disregard” of the truth

or falsity of the information being provided in support of a claim for payment, and requires no specific intent to defraud.⁷ As noted above, in most D&O policies, covered *Wrongful Acts* are defined to include “misstatements” and “misleading statements” by the insured. However, most D&O policies also contain so-called “fraud exclusions” purporting to preclude coverage for any intentionally fraudulent, dishonest, or criminal act or omission. Given the broad range of interpretations that may apply to these terms, coverage disputes may arise as to whether the representations that form the basis of an FCA claim are (despite being “knowing”) merely “misstatements” or “misleading statements” or whether they rise to the level of intentionally fraudulent or dishonest misrepresentations.

Again, this dispute likely can be avoided on the front end when purchasing coverage. Specifically, the fraud exclusion under many D&O policies applies only where there is a formal adjudication or admission of fraud. Because most FCA claims will be settled or dismissed with no formal adjudication, the fraud exclusion would not apply. Some fraud exclusions, however, do not require a formal adjudication or admission of fraud. Rather, these exclusions apply where the claim at issue merely alleges fraudulent, dishonest, or criminal

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conduct. Because allegations of such conduct are the norm in FCA claims, exclusions containing this broad language may severely restrict available coverage. Contractors should make sure that their D&O policy contains a narrow form of the exclusion.

Exclusion For Claims Made By an Insured

Most D&O policies contain some form of exclusion for claims maintained by, or on behalf of, any “Insured” under the policy. *Insured* often is defined broadly to include both the company and its officers and directors, and may also include the company’s other employees as well. Because most FCA claims are brought, at least initially, by “whistleblowers” within the company, insurers might argue that this exclusion precludes coverage for certain FCA claims. Government contractors should insist, therefore, that their D&O policies be issued without this exclusion or that the exclusion be narrowly drafted, for example by carving out whistleblower claims by current or former executives or other employees. Often such carve-outs are added to the policy by endorsement, and typically apply to claims where the executive’s or employee’s actions in bringing the FCA claim are protected under applicable whistleblower laws.

Definition of “Loss”

The definition of covered “Loss” in many D&O policies is subject to certain exceptions that could substantially limit the coverage available for FCA claims. Because these exceptions effectively function as exclusions, government contractors need to be particularly wary of them.

Pre-Claim Defense Costs

Many D&O policies do not include in the definition of covered “Loss” costs that are incurred by the insured in defending or investigating a matter that has yet to become a formal “Claim,” as defined in the policy, even if the matter ultimately becomes a Claim or the pre-Claim defense efforts ultimately benefit the defense of a later asserted Claim. Although the definition of *Claim* varies among policies, it typically includes (when applicable to the company):

- A written demand for money damages or nonmonetary relief,
- A civil proceeding commenced by some form of pleading,
- A criminal proceeding commenced by an indictment, and
- In some policies, a formal civil administrative or regulatory proceeding that is commenced by the filing of charges.

Insurers may contend that the issuance of a subpoena or commencement of an investigation by the government, without more, does not constitute a “Claim.” Thus, even though the company may ex-

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pend substantial sums in responding to a subpoena or defending an investigation that ultimately aids in the defense of, or even prevents, a subsequent claim under the FCA, insurers often argue that such expenses are not covered.

Again, policy language differs, and even though individual contractors may not have the negotiating leverage to demand wholesale modifications to the definition of Loss, they certainly should attempt to negotiate policy language that defines covered Claim and Loss as broadly as possible in order to mitigate the effect of the limitation. Also, by providing notice to their D&O insurer of a pending or threatened FCA investigation in a timely manner, as will be discussed more fully later, contractors may be able to persuade their D&O insurer to begin paying for the investigation or defense early in the process. In any event, simply understanding that pre-Claim legal defense costs may not be covered is an important strategic consideration for government contractors in determining how best to respond to potential FCA claims.

Multiple Damage Awards

Arguably, the most formidable aspect of the FCA is its nondiscretionary award of treble damages (or double damages where there are certain mitigating factors) for established violations of the act. For many contractors, such liability essentially would be a death penalty. Under many D&O policies, the definition of covered loss expressly excludes multiple damage awards. In light of the increased exposure of government contractors to FCA claims, they should seek to purchase D&O coverage that does not exclude multiple damage awards from the definition of Loss. Even if multiple damage awards are excluded under the applicable standard policy form, coverage for such awards can be added back into the policy by endorsement.

Other Key D&O Provisions

Entity Coverage and Related Allocation Issues

As noted above, D&O policies may cover only the company's officers and directors, or they may cover the company itself as well, depending on whether the insured elects to purchase optional entity coverage. Where a company elects to insure only its officers and directors and both the company and its officers and directors become the subject of a potentially covered claim, most D&O policies contain allocation provisions governing the extent to which the insurer will pay for defense and indemnity of the officers and directors. These provisions also typically address allocation of defense and indemnity costs with respect to claims alleging both covered and uncovered matters.

These provisions vary in important ways. For example, many allocation provisions state that Loss is to be allocated among covered and noncovered matters based on the relative legal and financial exposure to the insured presented by each. Others simply state that if the parties cannot mutually agree to an allocation, the dispute will be submitted to arbitration. Likewise, some allocation provisions apply only to indemnity costs but not to defense costs, which, given the substantial costs of defending many FCA claims, can have significant financial implications. In any event, contractors need to be aware of these provisions, particularly if they choose not to purchase entity coverage—not only so they can seek the most favorable policy language, but because they may limit otherwise available D&O coverage if the company later becomes the subject of an FCA claim.

Notice Obligations

Most companies know that they are required to provide timely notice to their insurer of claims against the company. Many do not realize, however, that under many D&O policies, they are also required

to provide notice of circumstances that could give rise to a covered claim once such circumstances become known to the company. Because providing timely notice of both claims and circumstances that could give rise to a claim is typically a condition precedent to coverage, failing to comply strictly with both obligations can result in a reduction of coverage or, in some cases, even a complete forfeiture of coverage.

Circumstances that could result in an FCA claim may become known to a company well before they materialize into an actual Claim, as defined in the policy.⁸ At such a time, the company is likely to be focused on internal investigation and damage control rather than seeking insurance for a Claim that has yet to be asserted. All too often, such companies fail to provide timely notice of these circumstances, thereby providing their insurer with a substantial defense to coverage. Accordingly, government contractors need to be mindful of, and strictly comply with, both notice obligations. Focusing on notice upon discovery of a potential claim may also provide the company an opportunity to conduct a more thorough investigation of the circumstances being reported, anticipate the insurer's potential defenses to coverage, and frame the notice in a manner that supports the insurance claim and avoids coverage defenses. Particularly with respect to the latter two objectives, the company would be well advised to consult with experienced coverage counsel.

Non-Rescission and Severability

D&O policies typically do not cover claims where relevant facts underlying the claim were known to the company at the time the company applied for coverage but were omitted or misstated in the company's application for coverage. Indeed, if during their investigation of a coverage claim, the insurer discovers information indicating that one or more individuals within the company had knowledge of

relevant facts that may have affected the insurer's decision to issue the coverage but failed to report or misstated such facts, the insurer may seek to rescind the policy altogether. In some cases, companies can purchase D&O coverage that, by its terms, cannot be rescinded by the insurer. This is often accomplished by addition of a "non-rescindable coverage" endorsement.

If non-rescission is not an available option, the company can also protect itself through so-called "severability" provisions. Typically, these provisions limit the individuals within the company whose knowledge is deemed relevant for purposes of representations in the coverage application, for purposes of providing notice, or for application of certain knowledge-based exclusions (e.g., fraud exclusions, as previously discussed). For instance, they may limit individuals who are deemed to possess relevant knowledge to certain specified officers or directors. They may also limit the imputation of coverage-preclusive knowledge among the various insureds, including the company. Thus, the narrower the scope of individuals whose knowledge is deemed relevant, and the less knowledge that may be imputed among the insureds, the less likely the company and its individual officers and directors are to lose coverage for an FCA claim, particularly where the circumstances underlying the claim are not widely known within the company. Contractors should carefully review their D&O policies prior to purchase to make sure they contain severability provisions applicable to the company's application for coverage and key knowledge-based exclusions and, where feasible, seek to negotiate the application of these provisions as broadly as possible.

Conclusion

Liability imposed by an FCA claim, as well as the costs of defending the claim, can have a monumental impact on a government contractor's business. The extent to which such liability and defense costs may be covered by the contractor's D&O insurance will depend on the specific terms of its policy. Because the terms bearing on coverage for FCA claims can vary substantially from policy to policy, government contractors need to review the terms of their D&O policies carefully and, where warranted, seek more favorable terms at renewal time. Because policy language is subject to legal interpretation, consulting with experienced insurance coverage counsel when purchasing D&O coverage is advisable.

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ENDNOTES

1. 31 U.S.C. §§3729 *et seq.* (civil component) and 18 U.S.C. §287 (criminal component).
2. Criminal violations of the FCA are punishable by fines and imprisonment. However, because criminal conduct and fines arising from such conduct are not covered by most liability policies, this article focuses on the civil component of the FCA.
3. Depending on the nature of the claim and the language of a company's policies, insurance other than D&O coverage could be implicated by an FCA claim. For example, a company's "Errors and Omissions Liability" or "Professional Liability" policy, which typically insures against losses for Wrongful Acts committed by the company in the course of providing specified "Professional Services," may also provide coverage for alleged violations of the FCA. Because both types of policies tend to be similarly structured, this article focuses on D&O policies, although much of the discussion applies equally to the other policies. In any event, companies facing actual or potential FCA claims should review (or ask experienced coverage counsel to review) all policies for possible coverage.
4. In many respects, this discussion also applies to D&O coverage for government actions brought under other laws governing the operations of many government contractors, including, for example, the Foreign Corrupt Practices Act (15 U.S.C. §§78dd-1, *et seq.*).
5. The better-reasoned opinions hold that the contractual liability exclusion applies only where the contract is the sole basis for the insured's liability, and does not apply if there is any basis for liability other than the contract. These cases further recognize that mere involvement of a contract in the circumstances of the insured's liability does not mean that the liability arises from the contract for purposes of the exclusion. *See, e.g., Harker's Distr., Inc. v. Federal Ins. Co.*, 2009 U.S. Dist. LEXIS 90820 (N.D. Iowa 2009) (contractual liability exclusion did not apply to suit against insured for refusing to redeem shares of stock pursuant to shareholder agreement because claimant "could have asserted a claim against [insured] for its wrongful acts under a legal theory independent of any contract"); *Church Mut. Ins. Co. v. U.S. Liab. Ins. Co.*, 347 F. Supp. 2d 880, 888-89 (S.D. Cal. 2004) (fraud claims where insured allegedly defrauded contractors by entering into contracts without any intent to pay them covered because 1) the insurer's broad interpretation would "eviscerate" coverage that otherwise expressly was provided under the policy and 2) "the gravamen of...the claims against [the insured] is fraud rather than breach of contract."); *Admiral Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 463 (N.D. Tex. 2003) (where insured entered into lease agreement under which its rent was paid in the form of stock that ultimately proved to be worthless, and insurer denied coverage for subsequent fraud claims based on contractual liability exclusion, court held that insured's "breach of lease is immaterial to the securities fraud claim because the alleged harm...occurred at the time the agreement to accept stock instead of cash was made. The lease contract did not cause the stock fraud claim, it simply provided the context in which the stock fraud took place.").
6. Examples of such arguments include the contractor's alleged liability arises under statute (the FCA), not the contract with the government (i.e., the contract is merely the context in which the liability arose); and if the exclusion applies as broadly as the insurer asserts, the policy essentially provides no coverage to government contractors due to the nature of their business and therefore cannot be enforced under uniform rules of contract interpretation (i.e., the exclusion renders any coverage the policy purports to provide illusory).
7. 31 U.S.C. 3729(b)(1).
8. For the reasons discussed later in this article, the company should seek to negotiate as narrowly as possible the scope of individuals within the company whose knowledge is deemed relevant for purposes of providing notice.