

## Payback: Can Settlements Of False Claims Act Claims Be Covered Under D&O Policies?

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In recent years, corporations have seen a dramatic upswing in claims alleging violation of the federal False Claims Act (FCA). Dating from the Civil War, the FCA at one time was a sporadically used civil law that made government contractors liable for fraudulent claims on the government. After the law was reformed in the 1980s to make it easier for individuals to sue on behalf of the government, employees and shareholders of corporations transacting with the federal government began viewing it as a powerful whistleblower statute. With the increase in lawsuits alleging violations of the FCA, insurance companies have become more aggressive in denying outright any obligation to pay settlements of FCA claims on the grounds that they seek uninsured restitution or disgorgement.

Contrary to what insurance companies may claim, however, the FCA provides for relief in the form of damages and civil penalties, not restitution or disgorgement. Fines and penalties imposed under the FCA nearly doubled from 2015 to 2016, so insurance companies have every incentive to chip away at coverage for FCA settlements.

### Some D&O policies cover False Claims Act claims

Most corporations purchase directors' and officers' liability (D&O) insurance policies with the thought of protecting against the risk of securities-related litigation and shareholder derivative lawsuits. They might not be thinking about whether such policies insure against FCA claims. This is understandable, because the history of D&O policies is closely intertwined with the enactment of the modern securities regulatory regime and developments in securities litigation. However, while modern D&O policies have an emphasis on securities-related claims, they can be written broadly enough to permit coverage of unrelated areas of corporate exposure.

For example, D&O policies cover claims for "Wrongful Acts," which are usually defined to include "any act, error, omission, breach of duty, misstatement or misleading statement" by the corporation or its directors, officers or employees. That language is broad enough to encompass virtually any act or omission, including fraudulent or dishonest conduct or actions which are not related to corporate governance, mergers and acquisitions or the marketing of securities.

While D&O policies separately contain exclusions for fraudulent or dishonest conduct, generally those exclusions apply only where there has been a final judgment in the underlying litigation establishing that the policyholder actually

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engaged in excluded conduct. That means allegations of fraudulent or dishonest conduct under the FCA are not necessarily barriers to coverage, as long as the case settles before trial.

Even though conduct in relation to an FCA claim may qualify as a covered “wrongful act,” insurance companies sometimes deny coverage on a theory that an FCA settlement is nothing more than a return of money obtained improperly, and not “loss” covered by the policy. Here’s their rationale: Many D&O policies specifically exclude restitution and disgorgement from covered “loss.” Even where the policy does not do so, the laws of many states prohibit insurance companies from covering such relief on the grounds that being required to return something that does not belong to the policyholder cannot be an insurable loss. The purpose of the FCA seems to fit within this paradigm; after all, the point of that law is to address situations where contractors wrongfully obtain payment from the federal government. Indeed, defense attorneys reporting to the insurance company often loosely characterize relief sought under the FCA as restitution or disgorgement.

Policyholders should not be deceived by any of this. The FCA provides for two forms of relief – treble damages and civil penalties – with the former making up the lion’s share of a defendant’s liability exposure under the statute. Courts interpreting the FCA have been clear that it is not a restitution or disgorgement statute. Following a detailed analysis of the history and text of the FCA, the Southern District of New York concluded that the statute “expressly provides for civil penalties and damages alone – and not for restitution.” *United States ex rel. Taylor v. Gabelli* (S.D.N.Y. Nov. 3, 2005) 2005 U.S. Dist. LEXIS 26821, \*40. Nor does the FCA provide for disgorgement of profits, another restitutionary remedy aimed at depriving a defendant of unjust enrichment. (*Id.* at \*49.) Rather, courts have characterized the treble damages available under the FCA as compensatory in nature, which would place such relief squarely within the D&O definition of “loss.”

## How insurance companies view the FCA

Even though the FCA is not a restitution or disgorgement statute, insurance companies may still insist that a portion of the policyholder’s exposure in an FCA claim is still not covered. Many D&O policies expressly exclude coverage of punitive damages, while many states prohibit insuring punitive damages even where the policy purports to cover them. Some courts have suggested that the portion of treble damages under the FCA beyond actual damages is punitive in nature. See *United States v. Bickel* (C.D. Ill. Feb. 22, 2006) 2006 U.S. Dist. LEXIS 29665, \*7. Some policies go a step further and exclude from coverage “the multiplied portion of multiple damages,” which could exclude coverage of those damages regardless of whether they are deemed punitive under applicable law. Finally, many D&O policies expressly exclude “civil fines and penalties,” potentially defeating coverage of the FCA’s civil penalties, which usually make up a relatively small portion of the policyholder’s exposure. If any of these limitations on coverage applies, the insurer may point to the policy’s allocation provision in an effort to reduce the amount of defense costs and settlement funds it must pay.

Many D&O policies contain a provision under which a settlement is allocated between covered and non-covered portions based on the “relative legal exposure” of the covered and non-covered claims. Under this method, the portion of the settlement allocated to non-covered loss is determined by how

much consideration of that liability exposure motivated settlement. Normally, this method is notoriously imprecise and heavily fact-based, and insurance companies sometimes use the specter of litigating allocation as a bludgeon for obtaining a discount on what they contribute to a settlement or defense costs. Policyholders are spared the brunt of this problem for FCA claims, because the FCA is relatively clear about how damages and civil penalties are assessed. Nonetheless, both policy language and public policy will determine to what extent the insurance company can allocate an FCA settlement to non-insured loss.

Policyholders need not accept assertions by insurance companies that their D&O policies simply do not cover settlements of FCA claims. In highly regulated industries where companies routinely do business with the federal government, FCA liability based on some internal mistake or rogue employee can be a cost of doing business, and D&O carriers selling policies in this space should anticipate legitimate claims for coverage arising from this exposure.