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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Special Insurance Coverage Issues For Gov't Contractors

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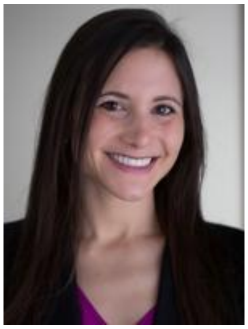

Peter Eyre   Rachel Raphael

Government regulations, compliance standards and the nature of government contracting work mean that companies doing business with the federal government face unique liabilities. These liabilities, in turn, present specific insurance and risk management considerations. This article outlines five considerations that government contractors should keep in mind when evaluating whether their business is adequately protected from an insurance standpoint.

The False Claims Act

The False Claims Act imposes liability on government contractors that submit false claims or certain false statements to the government. Actions under the False Claims Act can be brought by the government and/or individuals (so-called qui tam relators). These qui tam actions are in the form of liability claims and the qui tam relators stand to receive a portion of any recovery under the False Claims Act.

Questions arise regarding the coverage available under traditional insurance policies for some or all of the costs a contractor might incur in defending False Claims Act claims. A contractor’s directors and officers insurance policy, for example, may provide some coverage. Generally speaking, D&O policies provide coverage for a company’s directors and officers and/or the company itself for expenses and losses suffered in relation to lawsuits alleging wrongful acts by directors and officers committed in their capacity as directors and officers. These policies often contain regulatory exclusions which preclude from coverage certain claims brought by a governmental entity. But qui tam actions are brought by third parties in the name of the government, not the federal government itself. In some situations, this distinction may be material. Importantly too, D&O policies commonly contain exclusions for willful or intentional wrongdoing. Thus even for qui tam actions, the specific allegations against the government contractor may also impact whether coverage is available.

Nevertheless, subject to the other terms and conditions of the applicable professional liability policy, some coverage may be available for these types of claims. At the end of the day, however, the availability and extent of coverage depends on the specific policy language, the nature of the allegations, and the identity of the plaintiff.

The Defense Base Act

Government contractors doing work outside of the United States deal with a lot of uncertainty. Pursuant to the Defense Base Act (DBA), contractors must provide certain benefits to employees working outside the United States on US military bases or under a contract with the U.S. government for public works or for national defense. These benefits include compensation and medical benefits to covered employees and death benefits to eligible survivors of covered employees. Failure to obtain this insurance comes with serious consequences, such as fines, lost contracting opportunities and lawsuits.

Insurers offering DBA insurance policies may offer coverage beyond the statutory requirements, such as liability coverage for damages arising out of DBA claims and foreign general liability coverage. In light of the available options, government contractors must make sure they are covered for payment of DBA benefits and determine what coverage, if any, they want to secure beyond that mandated by statute. This determination is highly specific and requires a look by the contractor at its specific activities overseas and the areas of potential liability.

Contractor Default Insurance and Performance Guarantees

Federal, state and local laws occasionally mandate that government contractors obtain performance guarantees for certain types of public projects. Commonly, government contractors secure performance bonds, under which a third party surety (often an insurance company or a bank) issues a bond to guarantee the completion of a given project or projects and ensures payment of a sum of money to complete the contract if the contract is not performed in full. Upon receipt of a claim, the surety may perform an investigation to determine if there has been a default on the contract obligations and whether the surety is liable. If so, the surety will pay out funds subject to an agreed upon amount once this investigation is complete. The surety is typically entitled to indemnification when it pays out under a performance bond.

To protect against default of its subcontractors, some contractors opt for subcontractor default insurance (SDI) as an alternative to performance bonds. Generally, an SDI policy provides coverage for costs incurred in (1) correcting defective or nonconforming work or materials, (2) completing a defaulting subcontractor's work, and (3) investigating the default. A policy may also cover certain legal and professional fees, liquidated damages, and the increased overhead costs associated with default. Under an SDI policy, a contractor can unilaterally determine that its subcontractor is in default. If the subcontractor is ultimately not found to be in default, the insurance carrier must be reimbursed for the proceeds paid to the contractor under the policy.

For larger contractors with a significant volume of subcontracts, SDI may offer some benefits. For example, SDI typically (1) involves lower premiums, (2) allows the contractor greater control over the claims process and subcontractor qualifications, (3) provides coverage for entities that may not necessarily qualify for a bond, and (4) eliminates the waiting period that accompanies the surety's investigation following a default. In contrast, smaller contractors may find a surety relationship more advantageous because the contractors do not have the resources to conduct their own investigations of subcontractors and assess default risk. What form of protection best suits a given contractor is determined on a case-by-case basis. Regardless of whether a contractor opts to obtain performance bonds or SDI, the contractor must review the relevant bond conditions and/or insurance policy terms to assess the exposure in event of a default.

Government-Furnished Equipment

Government-furnished equipment (GFE) is provided by or bought on behalf of the government for use in connection with a particular contract. The equipment is considered government property and must be returned to the government once the contract has been completed (or otherwise dispositioned pursuant to the government's direction). While it is holding the equipment, the contractor is responsible for the safety and maintenance of the GFE and is liable if damages occur to or is caused by the equipment. Contractors are also responsible for making sure that subcontractors using the GFE do so properly.

Because the contractor is responsible for GFE during the duration of the contract, it is important that the contractor (1) make sure this property is covered by a general liability policy or, if not, (2) secure appropriate supplemental coverage. Although it is necessary to review the specific language of any insurance policy, contractors must pay particular attention to the complication added by GFE: the contractor assumes certain types of liability for this property (including that due to the misuse of subcontractors) even though this is considered the property of the government.

Cybersecurity

The federal government produces, collects and disseminates private and confidential data that concerns subject matter ranging from critical infrastructure and national security to personal information about government employees. Government contractors make for very appealing targets for cyber-attacks because they have access to and are entrusted with this highly sensitive information. Furthermore, not only are government contractors at a higher risk of being targeted, but they are also required to navigate the various rules, regulations, standards required to do work with the federal government.

A breach in these cybersecurity obligations can come at a very high cost. A contractor's failure to comply with cybersecurity standards in the past may have dramatic adverse consequences that contractor when it bids on future contracts, or otherwise preclude the contractor from certain future opportunities.

In addition to implementing appropriate measures to make sure they are in compliance with security requirements, government contractors should assess their exposure when and if a breach occurs. Contractors must examine their more traditional general liability and professional liability policies as well as any specialized cyber insurance policies to determine which of these policies will respond and when, how the policies interact with each other, and where gaps in coverage exist, if any.

Any company, large or small, is well advised to assess the potential liability arising out of its operations and take steps necessary to mitigate risk. But unlike a standard commercial entity, the rules and regulations, the sensitive and often highly classified information, and the nature of working with the federal government, make it all the more important that contractors are fully aware of the unique risks presented by the work they do. Beyond that, it is necessary that government contractors appropriately determine what coverage they need to obtain and in what form so that they are adequately protected in their business.

—By Peter Eyre and Rachel Raphael, Crowell & Moring LLP

Peter Eyre is a government contracts partner and Rachel Raphael is an insurance/reinsurance associate in Crowell & Moring's Washington, D.C., office.
