Del. Bankruptcy Ruling Will Give D&O Insureds Nightmares

By **David Klein** (June 27, 2024)

When is a claim "brought" against an insured?

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In last month's Henrich v. XL Specialty Insurance Co., the U.S. Bankruptcy Court for the District of Delaware's answer to this seemingly innocuous question turned into a nightmare for the estate of a bankrupt insured.

The insured, Insys Therapeutics Inc., was deprived of coverage under a claims-made directors and officers insurance policy for a claim filed three years after the retroactive date of the policy, on the basis that the claim arose from the same facts as an earlier False Claims Act suit that was filed before the policy's retroactive date but never served upon the insured.

How could this happen? The answer turns on the unique statutory procedures for filing a qui tam action under the False Claims Act. The act, originally passed during the Civil War, provides a mechanism for whistleblowers, called "relators" in the statute, to file a lawsuit on behalf of the federal government to recover for alleged false or fraudulent claims or payments.

The relator must initially file the lawsuit under seal and is not permitted to serve the defendant. Instead, the act allows the U.S. Department of Justice to review the sealed complaint and determine whether to proceed with it, allow the relator to prosecute it, or seek to stay the action. In a successful qui tam action, the relator stands to be awarded a share of the proceeds.

Qui tam actions have resulted in billions of dollars in recoveries for the government from healthcare providers, defense contractors and others.

But, as exemplified by the recent decision in Henrich, the act has created a nightmare for policyholders seeking coverage for litigation costs incurred in qui tam actions or related suits.

This is because D&O policies normally provide coverage for claims made and reported during the policy period or after a specified retroactive date, typically coinciding with the inception of coverage, and expressly exclude "prior and pending litigation," including related actions involving the same underlying facts or claims, brought before the retroactive date.

In Henrich, a relator had filed a False Claims Act complaint under seal in 2012, consistent with the act's requirements.

The complaint was dismissed before it was ever served on Insys, and Insys was unaware of the qui tam action when it later bought a D&O policy with a "Pending or Prior Litigation" clause that excluded coverage for wrongful acts "underlying or alleged in any prior and/or pending litigation or administrative or regulatory proceeding or arbitration which was brought prior to May 02, 2013."

Then, in 2016, the policyholder faced a shareholder derivative action based on the same

allegations underlying the earlier qui tam action, and sought coverage of its defense costs from its D&O insurer.

On May 29, the Delaware bankruptcy court granted summary judgment to the insurer, holding that the never-served qui tam claim has been "brought," within the meaning of the policy, before the policy's May 2013 retroactive date, so the 2016 shareholder derivative action was excluded from coverage.

The Henrich decision is simply wrong. To eliminate coverage based on the 2012 False Claim Act lawsuit, even though the complaint was dismissed before it was ever served upon Insys, the Delaware bankruptcy court put exceptional weight on the word "brought" and found no ambiguity in its application to the situation. The court wrote:

> Black's Law Dictionary defines "bring an action" as "institute legal proceedings," and it is common knowledge that federal legal proceedings — such as a qui tam suit under the False Claims Act — are instituted when the complaint is filed. See FED. R. CIV. PRO. 3 ("A civil action is commenced by filing a complaint with the court."); Bring an Action, Black's Law Dictionary (11th ed. 2019).

But the court's construction relies on generic definitions of broad expressions that give no consideration to context. The court distinguished the unmodified term "brought" from such phrases as "[a criminal defendant] 'brought' into court" or "claims … brought before a judge."

True, an action may be initiated by the filing of a sealed claim, but as a practical matter, it is not brought against the policyholder until the policyholder has been served. When a flexible word like "brought" is made to carry so much weight, principles of insurance policy construction give the policyholder the benefit of any doubt.

A counterfactual elucidates the problem with the Henrich court's analysis: Suppose a complaint is filed against a third party in 2013. The complaint is amended in 2016 to add a D&O policyholder as a new defendant. The policy has a retroactive date of 2014.

Should the policyholder's claim be denied because it was "brought" against someone in 2013 — or covered because it was brought against the policyholder during the effective period of the policy? Policyholders could lose a lot of sleep worrying about what they do not know.

Moreover, it is contrary to the purpose of D&O insurance to deprive a policyholder of coverage for a claim served upon them within the period covered by the policy. The purpose of D&O timing provisions is to ensure that policyholders notify their insurers soon after they know claims exist, not to deprive them of coverage because they are deliberately shielded from such knowledge under a statutory scheme.

In Henrich, the policyholder appears to have promptly notified its insurer of the shareholder derivative suit for which the company sought coverage, and it was undisputed that Insys was unaware of the prior, sealed-and-dismissed False Claims Act suit when it purchased the D&O coverage at issue. But none of this mattered to the Henrich court. Instead, the secret existence of a prior complaint eliminated coverage based on circumstances entirely outside the policyholder's knowledge or control.

Most policyholders would find it an unpleasant surprise to learn that a claim was "brought" on an earlier date when it was not served — literally, not "brought" to their door — until too

late, or, as in Insys' case, not at all. But this is a recurring nightmare in False Claims Act cases: The delay built into service while the Justice Department considers a claim creates a built-in tripwire to coverage.

Indeed, even in the absence of the sealed period built into qui tam actions, similar risk exists in any litigation that D&O coverage will be thwarted by the delay between a plaintiff's filing and the date the complaint is eventually served on the defendant. This is not the protection that policyholders bargain for when they buy insurance.

If followed by other courts, the Henrich ruling will leave policyholders exposed to fortuitous timing decisions by their adversaries — the relator and the Justice Department — taken entirely outside the policyholder's awareness. At placement or renewal, policyholders should explore the possibility of endorsing their policies to specify that when an action is filed under seal, it is deemed "brought" on the date the complaint is served.

In any event, policyholders should be diligent to notify their insurers as soon as practicable when they are served, and should otherwise ensure they take every possible step to preserve their rights to coverage.

They will sleep better if they do.

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